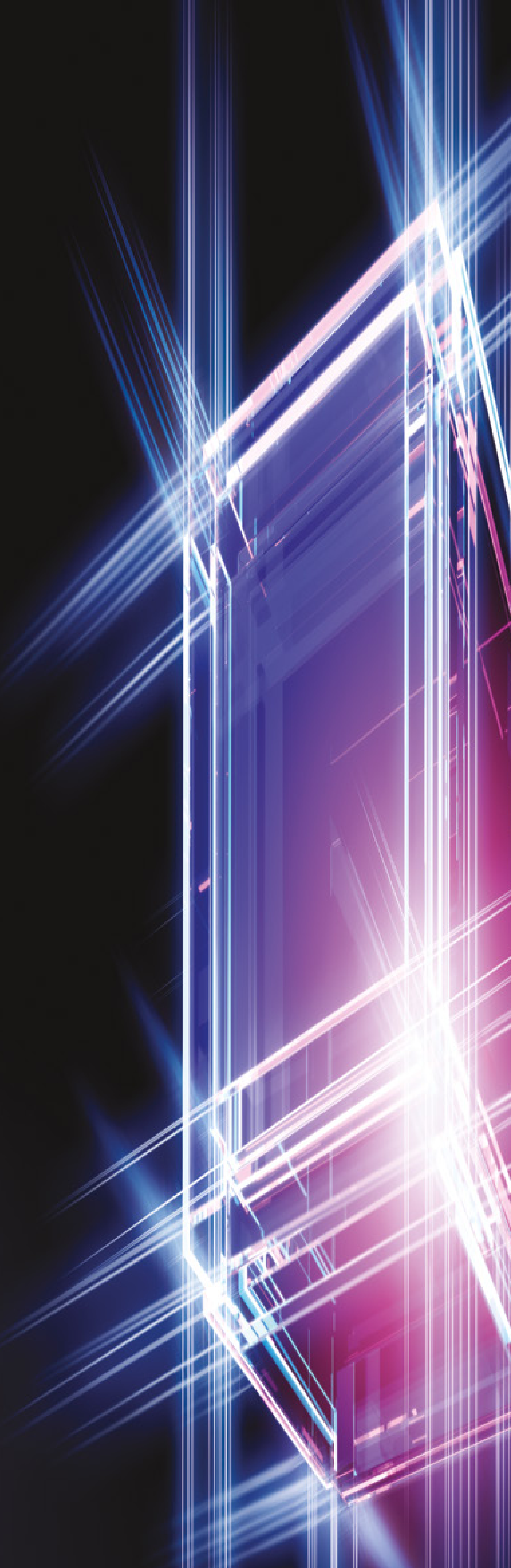


Credit Insights - by KPMG Cyprus Credit Institute

Bringing the Corporate and the Financial communities together

1st edition

May 2019

kpmg.com.cy

Table of contents

At KPMG in Cyprus we know what matters

- We know what it is like to face a world of increasing complexity, economic volatility, unrelenting technological developments and data overload
- we understand how borrowers and financiers find themselves under a never-ending array of intense daily pressures to consistently deliver results and quality in their respective sectors
- we appreciate the disparate worlds and divergent objectives of borrowers and financiers.

KPMG Cyprus Credit Institute (CI) has been set up with the aim of bringing the corporate and the financial communities together by:

- Establishing a professional platform for exploring and investigating economic and sectoral developments, technological advances, prevailing lending conditions, criteria and benchmarks, business rescue themes and preservation and maximisation of corporate value, regulatory and compliance updates, etc.
- Educating and disseminating best international practices on how to align a company's financing structure to help secure long-term viability, growth and development and to deliver strategic ambitions
- Creating an open dialogue and debate forum while sharing intelligent, insightful approaches to managing debt and financial affairs in a sustainable yet flexible manner vis-à-vis the company lifecycle stage and the changing, over time, requirements of financiers.

As economic prosperity can only be sustained via successful collaboration between businesses and financial professionals, KPMG Cyprus CI's vision is to become the local centre of excellence for exchanging ideas and aligning the interests of the corporate and the financial worlds.

KPMG Cyprus CI will be publishing and distributing its Credit Insights newsletter which will explore subjects of interest (news and analysis) in a series of discerning articles and knowledge sharing from KPMG specialists. KPMG Cyprus CI will also organise unique, exclusive events which will be value-packed with local and international acclaimed field experts and will provide insightful discussion and networking opportunities.

In this inaugural edition of the Credit Insights you will find articles covering the following themes:

i. Debt Advisory in a Complex World. Touching upon the importance of an efficiently operating debt market in the new world order of ceaseless business upheaval
ii. Corporate rescue. Following on from the introductory topic, we investigate the pre-requisites for a sustainable turnaround for businesses in distress and discuss the role and duties of directors in preserving the health of their companies. The 'Necessity of Corporate Rescue and Turnaround' will indeed be the emblematic theme of KPMG Cyprus CI's inaugural event.

The next Credit Insights edition will follow up with related topics on:

i. Corporate sector Non-Performing Loans: which way? An investigation, on the basis of statistical figures, of whether corporate rescue is indeed taking place in Cyprus and a discussion of the European Union initiatives on NPLs, which will have a profound impact on the banking and corporate worlds in the coming months
ii. Lending conditions in the local market. An analysis of how new lending to non-financial corporations is developing and an overview of the prevailing lending sentiment and the banking criteria for lending to the real estate and hotel sectors, which are by far the largest segments of the total loans pie, but also form a substantial portion of NPLs.

Our team welcomes you to the KPMG Cyprus CI and to this first edition of Credit Insights.

"We can only do what we know". In a world overwhelmed by an overload of data, clarity, knowledge and insight have the power to transform. And this is exactly the objective of our Credit Insights: to transform.

At the same time, we are committed to listening carefully and tuning in to your needs and requirements, into the matters of concern to you, to further refine and calibrate our effort.

Debt Advisory in a complex world: what and why?

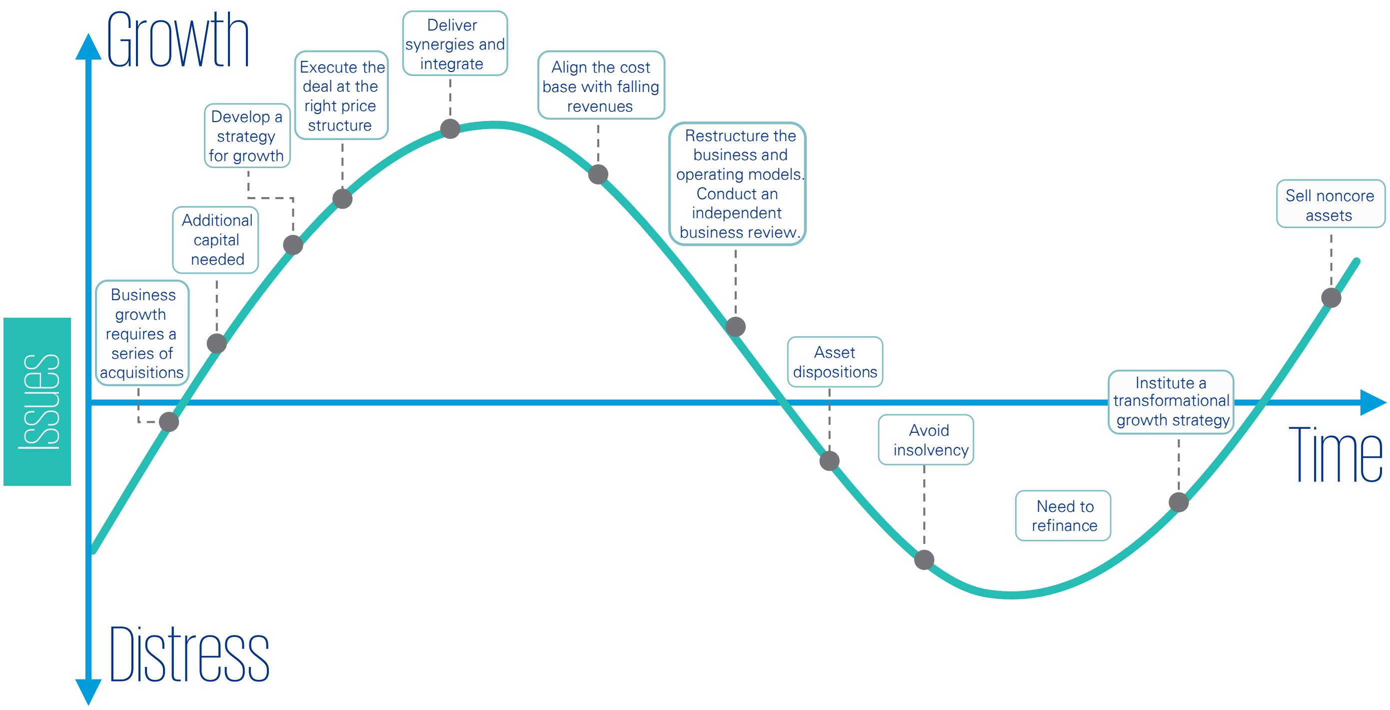
The importance of the debt market
An efficiently operating debt market is always the trademark of a well-functioning economy and typically forms the backbone for business expansion and economic growth.

The years following the 2013 crisis have seen the local debt market undergo a revolution:

- with much tougher lending criteria, which have limited the availability of funding (despite banks' liquidity), a scarcity which is particularly pronounced for small to medium enterprises
- a significant deleveraging effort by banks, leading to intense pressure on over-leveraged companies and a subsequent corporate 'clean-up' between viable, potentially viable and non-viable entities
- a sharp on-going consolidation of the banking market
- the emergence of challenger banks, debt servicers and credit acquiring funds
- the entrance in the international scene of status quo disruptors such as fintechs, private debt funds, crowdfunding platforms and other peer-to-peer lending, albeit at a much slower pace locally.

Indeed, it is the significance of the debt market and of these emerging trends that form the 'raison d' etre' of the Credit Insights newsletter series. Coverage of these issues starts in this first edition and more detailed analysis and other in-the-news topics will be included in subsequent editions.

Strategic financial and capital management
Arguably, in this fast-pacing era of unprecedented changes, economic uncertainty, business volatility, ceaseless upheaval and intensifying regulatory pressures, it is crucial that a company's financing is aligned with its short and longer term strategic ambitions through the business' lifecycle (diagram); whether it relates to refinancing of existing debt, dealing with financial stress, funding a growth strategy, or raising capital in the markets.



Even the most experienced and capable business leaders are often overwhelmed by tending to the intense day-to-day operational issues and challenges, leaving little or no time to deal with a dizzying multitude of time-crucial financing-related decisions:

- Debt raising and refinancing: sustainable debt capacity evaluation, available options assessment, structuring and terms, execution
- Restructuring and negotiation: corporate rescue and turnaround, restructuring options assessment, robust financial restructuring plans backed by risk-adjusted sensitised cash-flow forecasts, management of lender relationships, negotiation of loan modifications, covenant adjustments and facility extensions, negotiation assistance with other stakeholders (e.g. authorities), critical assessment of operations to maximize cash generation
- Acquisition and growth funding: design and execution of funding strategies for M&A initiatives, strategic growth opportunities and large capital expenditure projects.

The ever-changing business setting highlights the importance for organisations to employ sustainable levels of debt funding whilst, at the same time, having debt facilities with the flexibility to act on opportunities presented in the market. This is precisely the role of debt advisory and professional experts: bringing corporate entities and financiers together, aligning their interests and expectations and navigating them to the right debt and capital structuring.

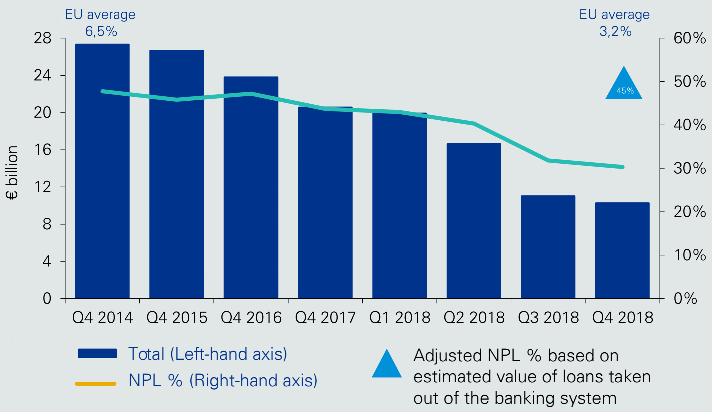
The Challenges

Poorly planned debt levels and structures can result in missed opportunities, wasted management effort, reduced profitability but, equally, if not more importantly, they can give rise to increased risks and financial distress, as we have witnessed in Cyprus over the past years. Inefficient debt structures may indeed be lethal for borrowers, but also for their lenders alike, and thus require immediate rectification.

Prudent debt management becomes even more important when viewed against the backdrop of the excessive indebtedness of our local private sector and the high stock of non-performing loans which is hampering our economy particularly the small to medium enterprises and the household sectors (diagrams).

Corporate indebtedness and the cost of corporate failure provide the context of the next topic of our newsletter, which will investigate the theme of corporate rescue and whether it is doable or not.

Non-Performing loans



Q4 2014

47,8%

€27,3 billion

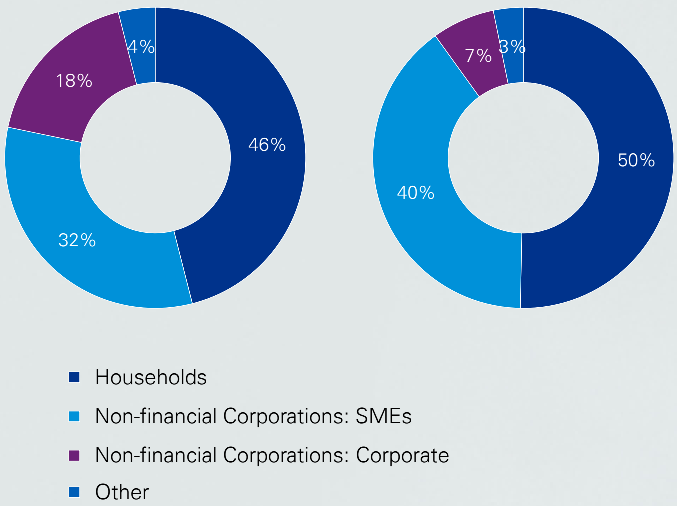
Q4 2018

30,3%

€10,3 billion

-62%

-€17,0 billion



Corporate Rescue: is it doable?

A thought-provoking question to which the unambiguous answer is yes. But, as usual, there are conditions and provisos, all based on practical experience and extensive empirical research.

Corporate rescue pre-requisites

- Late reaction is the single most important reason for highly leveraged businesses becoming unsustainable and heading towards liquidation. The clock is ticking; the more a company delays to detect and face reality and take action, the greater the risk for a disastrous downturn and rapid value erosion
- Inappropriate governance structures are relevant in determining timeliness in addressing distress. A number of companies simply procrastinate facing reality; as a result of lack of relevant expertise and knowledge in the area, inferior reporting systems and monitoring, poor financial information, but possibly and more pronouncedly, because of emotional attachment which may result in denial of the business' critical condition and irrational and unfounded optimism that sooner or later the crisis will somehow pass

  Often, there is reluctance to admit to the situation and address it openly and constructively; there is a state of fear of admitting weakness and of concerns about reputational stigma and losing control
- Adequate knowledge and experience-based professional advice can be a critical aspect in corporate rescue; management teams and owners generally lack the restructuring expertise, resources or credibility necessary to effectuate a successful turnaround
- Failure to obtain competent professional advice can cause a debtor, especially small and medium enterprises, to choose inadequate or inappropriate courses of action which may not be sufficient for rescuing the business. Plan inadequacy is often the reason for the need for consecutive rounds of restructuring and/or of creditor unwillingness to go the full mile, leaving the company saddled with too much unsustainable debt
-
- Following on from the last point, banks may lack the necessary proactiveness and urgency, which manifests in potential delays to handle/negotiate with smaller debtors, possibly due to sheer overload, or by showing a propensity to reschedule, without adequate analysis of true viability ('evergreening')
- The conclusive evidence from the research is that companies in financial difficulties can only be saved when a process of active turnaround and stakeholder management is initiated. The real issue in a rescue attempt is bridging communication and expectations gaps, regaining lost credibility and, ultimately, rebuilding trust amongst all parties involved.

The crucial role of company directors in corporate rescue

The European Commission (EC) has taken a decision to shift the focus away from liquidation, towards encouraging viable businesses to restructure at an early stage in order to avoid insolvency and therefore:

i. maximise total value to creditors, employees, owners, suppliers and the economy as a whole

ii. reduce unnecessary liquidations of viable companies

iii. prevent unnecessary job losses and losses of knowledge and skills

iv. prevent the build-up of NPLs.

The key to success for preventive rescue is directors' proactiveness and timing. As per the EC's proposal for a directive on preventive restructuring, member states must have in place the necessary legislative provisions to ensure that directors fulfil their duties and obligations with related punitive actions and liabilities.

So, where an enterprise is experiencing financial difficulties, directors have a duty to take immediate steps to minimise losses and to avoid insolvency. Examples of these steps include: seeking professional advice, using early warning tools, protecting business assets and avoiding loss of key assets, examining business viability and reducing expenditure, holding negotiations with creditors and seeking to enter preventive restructuring procedures.

In addition, the proposal highlights the importance of protecting the legitimate interests of creditors, workers and other stakeholders and of taking immediate steps, where a debtor is in the vicinity of insolvency.

It is obvious that there is a legislative move towards being more creditor-oriented in the situation where a company is in the vicinity of insolvency; this happens when the directors of a company continue to trade a company past the point when they knew, or ought to have concluded, that there was no reasonable prospect of avoiding insolvent liquidation and they did not take every step with a view to minimising the potential loss to the company's creditors ('wrongful trading' under English law). This shift will have profound implications on company directors as it will expose them to an increased risk of incurring personal liability if they allow their company to continue to trade while insolvent.

Consequently, directors must be alert to:

- Monitor their company's affairs and detect early signs of distress; it stands to reason that they must have internal controls in place and up to-date financial records
- Act proactively to give their business ample ammunition to heal; this is also a powerful incentive to them, given that taking early action maximises the chances of keeping control of the company and also preserves reputation and goodwill
- Engage with key stakeholders, particularly creditors, providing them, in a transparent way, with ample insight into the financial situation of the business
- Act on a plan: get competent and unbiased professional advice to draw up robust and realistic plans which will meet stakeholders' expectations.

The role of Debt Advisory

Many 'healing' approaches focus on how to cure the symptoms which are stressing the 'patient' without fully considering what led to the manifestation of the illness in the first place. The expert debt advisor will thus embark on a journey of change by 're-cognising' (which literally means to 'know again') and rethinking the business model with unclouded vision.

It is often the case that for a company to return to full health, viz viability, it needs a holistic approach which takes the form of:

- operational restructuring, that is a restructuring of the assets and the operations of the debtor which will lead to direct enhancement on profit and cash flow; this is not common practice in corporate Cyprus but is typically an essential part of long-term 'healing'
- financial restructuring, in the form of a restructuring of the debtor's capital structure and liabilities which tends to have quicker results compared to operational restructuring but may not properly deal with the underlying causes of distress.

Additionally, the debt advisor will use his/her independent professional capacity to actively manage damaged relationships by restoring communication, credibility and trust between the stakeholders, by bridging expectation gaps and by bringing consensus on the negotiating table.

Conclusion: the context of 'doability'

Corporate rescue preserves economic growth and sustainability and should be thus facilitated by the prevalence of a corporate rescue culture among key stakeholders.

This corporate rescue culture necessitates company directors to move outside their comfort zones to face reality head-on with a clear mind. Corporate rescue is a difficult path; but a path that needs to be courageously travelled nevertheless.

Stakeholder support, built on trust and transparency, is an absolute pre-requisite, otherwise rescue is doomed to fail. Lenders are typically the most important stakeholder in the process. A corporate rescue culture requires lenders to be proactive and ready to lend a helping hand to the forthcoming, well-meaning debtor.

Debt advisors have a crucial role to play in this interplay between borrowers and stakeholders, acting the role of the honest professional intermediary who will converge everybody's attention to the task at hand: doing corporate rescue in a collaborative, vigorous and solid way to secure sound, long-term corporate health.

The key message is simple yet very powerful. The interests of all stakeholders are intrinsically inter-related in a two-way relationship: corporate survival aids banking health and fuels economic growths.

The "doability" of corporate rescue rests firmly in the hands of key stakeholders: the corporate and the financial communities.

The next edition of Credit Insights will investigate whether stakeholders are indeed doing 'everything in their hands' to reverse financial distress and to promote corporate rescue.

KPMG Debt Advisory and Debt Management services

01 New project financing

- Feasibility studies
- Investment appraisals
- Business and asset valuations
- Business plan reviews and assistance
- Financial forecast reviews
- Model review and assistance

02 Borrower and lender financial restructuring assistance

- Independent Business Reviews
- Financial restructuring plans (liabilities rationalisation)
- Refinancing assistance
- Stakeholders negotiation assistance
- Restructuring options identification, assessment and monetisation

03 Crisis Management & Turnaround

- Cash crisis management and cash flow stabilisation
- Operational restructurings (assets, profit and loss and cash flow optimisation)
- Corporate turnaround assistance
- Turnaround executive/chief restructuring officer appointments

04 Asset and Debt management services

- End-to-end Debt for asset transaction implementation (strategy, negotiation, execution)
- Real estate asset due diligence (financial, technical, zoning, tax)
- Valuations reviews
- Asset management planning, portfolio optimisation and exit strategies
- Loans servicing insourcing and outsourcing
- End-to-end foreclosure procedure insourcing and outsourcing

05 Corporate Recoveries

- Receiver/Manager appointments
- Liquidation appointments
- Act as Court appointed officers
- Independent expert reports
- Insolvency expert witness reports

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