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Business insolvencies: Private equity the white knight?

The right employees, the timing for lodging the application and the receipt of insolvency money - these are the decisive factors for ensuring the rescue of insolvent companies according to German insolvency administrators. They are also pinning their hopes to private equity investors to bridge the liquidity shortfalls caused by overly risk-averse banks in their relations with small and mid-size enterprise.

Germany's insolvency administrators would welcome greater involvement on the part of private equity investors in efforts to restructure insolvent companies. This is the result of a survey recently conducted by Euler Hermes Kreditversicherung, the German subsidiary of the credit insurance leader Euler Hermes, and Zentrum für Insolvenz und Sanierung at the University of Mannheim (ZIS). In the representative study, a total of 106 top German insolvency administrators across the country currently handling 20,500 corporate insolvencies were asked to describe the conditions under which it is possible for companies to be rescued and the importance which private equity investors have in this connection. The survey was supplemented with an additional random sample of 69 private equity managers, consultants and restructurers.

Small and mid-size companies have a 50 percent chance of survival

Of the roughly 30,400 corporate insolvencies in 2006 in Germany, most were accounted for by small and mid-size companies with revenues of less than EUR 5 million. Insolvency administrators consider the odds of a successful bail-out to be low: 65 percent of the insolvency administrators questioned thought that for companies with revenues of less than EUR 0.5 million the only avenue available was liquidation. Small and mid-size companies with revenues of between EUR 0.5 million and EUR 5 million have a 50 percent chance of survival.

It is precisely in the case of insolvency that finance plays a crucial role. 78 percent of the insolvency administrators surveyed see "the risk aversion of banks, which prefer to grant loans to investors rather than to ailing companies," as the main obstacle to successful restructuring. Nor do most insolvency administrators think that it has become any easier in the past five years for insolvent companies to raise finance.

"Unfortunately, we must assume that the current crisis afflicting the financial markets will cause this situation to worsen. This means that it will be even more important for companies to avoid liquidity shortfalls from occurring from the outset, for example by means of appropriate receivables management," says Gerd-Uwe Baden, CEO of Euler Hermes Kreditversicherung.

Private equity investors less interested in already insolvent companies

Although most administrators are in favor of greater support by financial investors, only 39 percent actually expect such involvement. According to insolvency administrators, the most important criteria in financial investors' decision to invest in insolvent companies is the scope for acquiring a majority stake in the company for restructuring it from bottom to top.

However, the interviewees in the second group, private equity managers, consultants and restructurers, see far greater potential for financial investors in ailing companies which have not yet lodged an application for insolvency. Whereas 39 percent answered the question as to the importance of private equity for insolvency companies by saying that they thought it was important, 73 percent considered this to be the case for companies in a crisis situation. Private equity managers' argument basically goes like this: "We prefer to avoid insolvency and seek to remain in charge of the process." According to this group, private equity companies are primarily



interested in companies with revenues of over EUR 10 million and preferably even over EUR 50 million.

What stands in the way of restructuring, what furthers it?

According to 98 percent of the insolvency administrators questioned, insolvency money plays a crucial role in salvaging ailing companies particularly in the first phase of insolvency. It is only with this funding provided by the labor exchange that it is possible to cover ongoing personnel costs in particular and to continue business operations.

“For this reason, it is vital to prevent any attempts to abolish or reduce insolvency money, as it plays such an important role in Germany in efforts to restructure ailing companies,” explains Georg Bitter, chairman of ZIS.

84 percent of the insolvency administrators consider Section 613a of the German Civil Code, which stipulates that the entire staff must be transferred to the new owner, to be a decisive hurdle which must be overcome when an insolvent company is sold to a new owner. Although there are numerous ways of getting around this in practice, these options are generally only available for large insolvent companies. “Accordingly, it is necessary to render Section 613a of the German Civil Code more flexible in cases of insolvency to rescue jobs. After all, what is the point of a law which purports to protect employees but effectively stands in the way of restructuring and, hence, efforts to preserve jobs?” asks Bitter.

The study reveals that as a matter of principle three conditions are decisive for the insolvent company’s continued existence: key employees must be retained, there must be sufficient orders and the company must still be active in the market.

Insolvency administrators’ competence important

The success in restructuring insolvent companies hinges upon the skills of the insolvency administrators. Considerable criticism is voiced at both the selection procedures used by the insolvency courts as well as the shortcomings in the training of many insolvency administrators. 50 percent of the insolvency administrators surveyed find fault with the selection practices of the courts, while 51 percent criticize the inexperience of many a colleague. “In the selection of insolvency administrators, not only legal knowledge but also business skills should count. It is wrong to assume that any lawyer who has specialized in insolvency law makes a suitable corporate insolvency administrator,” explains Markus Ernestus, an insolvency administrator and member of the ZIS board. “It is necessary to attach more importance to the insolvency departments of the courts and particularly to provide them with better personnel and financial resources to make use of opportunities for restructuring and thus to save jobs.”

For more information on Euler Hermes, please visit www.eulerhermes.com

Further information on ZIS is available at www.zis.uni-mannheim.de

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