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"MANAGEMENT OF ECONOMIC AND FINANCIAL DISTRESS IN HIGHLY-LEVERAGED FIRMS: SEAT PAGINE GIALLE CASE STUDY"

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Firma dello studente

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To all my family,
especially to my mum, my dad,
my sister and my grandma,
who have always sustained me

A tutta la mia famiglia,
specialmente a mia mamma, mio papà,
mia sorella e mia nonna,
che mi hanno sempre sostenuto

"What this all comes down to is simply withdrawing the warm blood of equity and replacing it with the cold water of debt"

Fred Hartley, CEO of Unocal

(As reported by Müller and Panunzi, 2004)

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INTRODUCTION

This thesis is centred on issues which are assuming rising impact for investors: the management of business' decline and resulting situations of financial distress. Although, according to life-cycle theory, decline and crisis in individual firms or entire industrial sectors are considered physiological phenomena in modern economic systems, their occurrence inevitably impacts the regularity of operating activities, the relationships between business and external stakeholders and, if the situation is not timely overcome, it may threaten the independence or the survival of the organization.

It follows that business decline and financial distress are carefully studied by Financial Economics and Managerial Sciences, moreover they tend to be regulated by legal systems because in these situations the decision-makers have the incentive to adopt opportunistic and inefficient choices, likely to damage the environment where the firm lives in. In fact, the inevitable presence of asymmetrical information between internal and external stakeholders in a distressed firm creates a situation of tension about the distribution of the required sacrifices to sort out the situation of decline and distress. The tension among parties open the room for delays in recognition of causes and real dimensions of the business' decline by management and controlling shareholders, which is likely to result in intervention with limited scope and low effectiveness; on the other hand, external stakeholders fear excessive impairment of their right and the interruption of regular relationships with the distressed firm. Consequently, many clients and employees abandon the distressed firm, while suppliers ask for immediate payment and creditors try to enforce their contractual right. In this messy situation, the declining business is likely to lose the possibility to focus on its core activities and to safeguard the residual value of key assets and resources, leading to further disruption of value and need of transformations which usually involve management team and shareholding structure.

The thesis is aimed at presenting the available pathways to deal with situations of business decline and crisis, underlying their aspects at the light of the need to ensure the efficiency of economic system: it means that businesses with residual intrinsic value should continue, while businesses without significant value should be liquidated. Different restructuring procedures presents positive and negative aspects, and their choice shall be made under the light of the actual situation of the distressed business, to avoid extra costs and inefficient solutions which damage the overall set of stakeholders.

With respect to this work, Chapters 1 and 2 are aimed to properly describe, with the help of scientific and managerial literature, the situation of decline and crisis and the ideal pathway for the return to growth. As introduction, Chapter 1 describes the features of business decline and the so-called turnaround process from a managerial point of view. Chapter 2 is focused on the presentation of the set of legal instruments available to sort out situations of corporate crisis and financial distress. It is developed starting from the need to consistently rule the managerial behaviour in financial distress, then by presenting the set of institutions provided by legal systems to reorganize or liquidate a distressed business, with a focus on the distinction between out-of-court reorganizations and judicially-controlled proceedings. The aim of Chapter 2 is to describe the dynamic of the negotiations between the distressed firm and its stakeholders, which are influenced by the choice of a judicial or non-judicial composition procedure, so it tries to present a profile of costs and benefits of both type of procedures, to suggest the choice of the way which best fits for the corporate situation.

Then, Chapter 3 provides the description of the role of debt from a financial and managerial point of view: while in normal periods it is a useful tool to ensure wise managerial choices and maximize overall value creation through the fiscal shield of interest expenses; as suggested by Damodaran (2008, page 363), “debt is a double-edged sword [and] declining firms often are exposed to the wrong side”, since in decline and crisis unsustainable debt burden accelerates disruption of value and created difficulties in making decision in the best interest of internal and external stakeholders. Also, the chapter briefly describes specialized active investors who deal with debt to create value: Private Equity Investors, aimed at sustaining growth and efficiency of target businesses, and Distressed Investors, who tries to turnaround distressed firm through massive acquisition of distressed debt claims.

Finally, Chapter 4 and 5 are focused on the application of the tools to a complex case study about the restructuring of Seat Pagine Gialle: the business faced a sudden decline of its core products which, combined with very high debt burden arising from a leveraged acquisition undertaken by Private Equity investors in 2003. After a period of stability, at the end of 2008 the business was uncapable to repay debt and it entered a long restructuring procedure from 2009 to 2015, characterized by multiple out-of-court attempts and a final judicial procedure of Composition with creditors. While Chapter 4 describes the origins of Seat Pagine Gialle crisis, the historical steps of restructuring and its result with the help of official financial statements and legal documentation, Chapter 5 analyses the controversial aspects of the managerial choices putting the attention on the performance of its shares in the Stock Exchange and on the opinions issued by equity analysts. Despite its complexity, the case study seems to exemplify the critical aspects of negotiation among involved stakeholders, the negative effects of improper restructuring interventions, together with the potentiality of legal instruments in sorting out from situations of high financial distress.

CHAPTER 1: VALUE CREATION, DECLINE AND TURNAROUND

1.1. FIRM AND VALUE CREATION

It is widely known by managerial science that the firm is a combination of tangible, intangible and human resources, aimed at growing and creating value over time by satisfying the needs of clients under the constraints of effectiveness and efficiency. The firm is not a closed and unchangeable system, but it has some similarity with a living being. A firm is continuously in contact with stakeholders, such as shareholders, competitors, suppliers and public institutions, entertaining many complex relationships with its complex environment.

More specifically, Falini (2011) suggests that the firm is an open set of organized resources where each component takes a specific role within an overall coordination ensuring the achievement of the common aim of the business. The vitality of the business depends on continual exchange of resources with the external environment, which usually has a significant influence on its evolution. This set of resources is valuable since the presence of coordination determines the creation of an overall value higher than the sum of values of separate components. Ultimately, to preserve its vitality, the firm is continuously asked to identify and improve its sources of value and defend them from inevitable deterioration due to competition and changes in technology and in the environment where the firm operates.

According to Koller *et al.* (2015), value is the difference between the cash inflows and the cost of the investment sustained to achieve those inflows, adjusted for the time value of money and the risk that the future net cash flows do not occur. There are two relevant variables that determine the conversion of revenues into cash flows: *Return on Invested Capital (ROIC)* and *growth rate* of operating income. More specifically, the precondition for value creation is the fact that the ROIC is higher than the cost of Invested Capital, then, if this condition holds, the growth rate amplifies the magnitude of value creation.

Return on Invested Capital drivers are specified in the following formula:

$$ROIC = (1 - Tax\ Rate) * \frac{Unitary\ Price - Unitary\ Cost}{Unitary\ Invested\ Capital}$$

Ultimately, Return on Invested Capital depends on the industry structure and on the strategy pursued by the firm. Michael Porter, in his famous five forces model, suggests that the performance of an industry depends on the combined effect of these factors: the threat of new entrants, the availability of substitutive products, the degree of rivalry among competitors, the bargaining power of suppliers and customers. The ability of a certain business model to pursue a strategy that mitigates the intensity of these forces, guarantees to the firm implementing the business model a competitive advantage that ultimately leads to higher profitability. In fact, the strategy allows the firm either to charge a price premium or to reduce the unitary cost and the need of invested capital. The higher profitability is measured by a higher level of Return on Invested Capital with respect to the firms in the same industry.

More specifically, the competitive advantage belongs not to the whole firm but to each business unit within a certain firm, which is a specific product or service that is sold through a peculiar marketing mix. The most relevant sources of competitive advantage which allow the firms to charge a sustainable price premium while contrasting the effects of the Porter's five forces, can be summarized as follows:

- Innovative goods and services;
- Higher quality perceived by the consumer;
- Powerful brands;
- Lock-in of customers due to high effort needed for the substitution of the supplier;
- Barriers to entry of new players due to legal, technical or natural constraints;
- Limitation of production capacity in the whole industry.

On the other hand, competitive advantage allows the firm to produce and sell a good or service at a lower cost or unitary invested capital with respect to competitors. Some factors that affect cost and capital (so the dimension of efficiency) are:

- Innovative business models that build up new relationships in the supply chain and distribution channels;
- Access to unique and valuable natural resources;
- Economies of scale;
- Scalability of a product or process. (Koller *et al.,* 2015, page 99)

The sustainability of a competitive advantage is a relevant issue, because, in a market economy, the combined effect of competition, access to innovation and obsolescence reduces the ROIC over time by setting it equal to the cost of capital and this phenomenon stops the creation of new economic value. Therefore, to retain a sustainable competitive advantage, as suggested by Favotto *et al.* (2012), the firm should own and control a couple of resources with these following specific peculiarities. The resources shall be scarce, difficult to replicate and difficult to substitute, in the sense that their replication and substitution are characterized by high costs, long time needed and high uncertainty on results, and these factors discourage potential investments by competitors, since they would trigger high risk of economic losses.

For example, an innovation which may be easily replicated by competitors, such as self-check-in machines in the airport, does not grant a sustainable competitive advantage to the first airline company implementing it. In fact, other airlines, having access to the requested technology, easily imitate the first-mover, so the benefit in the form of lower personnel cost, is progressively deteriorated by the dynamic of competition and, at the end of the day, it is shifted from the airline to the final customer (Koller *et al.,* 2015).

Another feature that a resource should possess to ensure a sustainable competitive advantage, is the imperfect mobility, in the sense that these valuable assets are difficult to exchange in the market because they are very complex and entrenched with the business where they have been originated. Finally, the firm owning the resources must have the capabilities to exploit them and to extract the connected benefits, otherwise the resource naturally loses its value. (Favotto *et al.*, 2012)

1.2. CYCLICALITY OF BUSINESSES

Notwithstanding their effort to defend competitive advantage from deterioration by preserving the existing resources and by investing into growth and development of new valuable business opportunities, all firms and their industries experience a cyclicality: according to Gao & Alas (2010), who refer Allen's study, firms are considered to have a life-cycle which can be divided in a couple of stages. In Allen's opinion, the firm's life is divided into five stages: "*Pre-Start-up, Start-up, Growth, Maturity* and *Rebirth* or *Decline*", but it is specified that "the *Pre-Start-up* stage is when the enterprise's concept is formulated, the enterprise does not indeed exist until the "*Start-up*" stage" (Gao & Alas, 2010, page 12). Each stage can be identified through the study of a couple of variables: age, size, focus, diversity and complexity.

It follows that, over time, firms modify some of their key aspects, such as consistency of assets and resources, number of employees, revenues or financial indicators, and, by measuring the level of some reference variables, it is possible to classify a firm in its stage of life-cycle. During each step of the cycle, the final aim of value creation must be declined by directors and managers into different focuses. In the Start-up phase the firm is focused on survival and awareness, through identification of target market, attraction of customer and attention about financial resources. Then, in the Growth phase, the aim is to expand and to rapidly increase sales and market share. In the Maturity Phase, sales become stable and the firm focuses on profits and margins, which are threatened by increasing competition and innovation. (PAIB 2006)

From a practical point of view, it is possible to measure the level of revenues and earnings and to see that, in normal conditions, they follow a predictable pathway: they rise during the Start-up and Growth phases, they reach their maximum in the Maturity phase and they fall in the last stage. The behaviour of these economic variables can be represented in Figure 1.1 and then explained in Table 1.1.

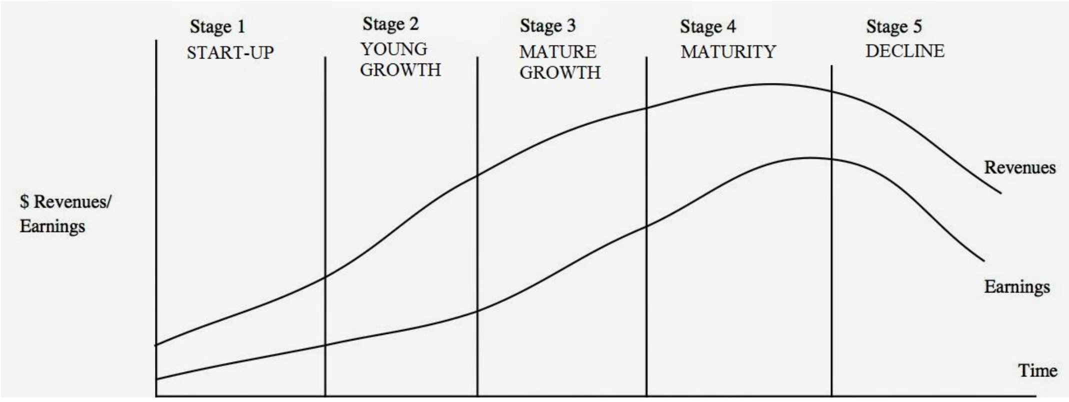

Figure 1.1 – Dynamics of Revenues and Earnings during business life-cycle
Source: Damodaran (2010), page 8

	START-UP	YOUNG GROWTH	MATURE GROWTH	MATURITY	DECLINE
Revenues	Non-existent or Very Low	Increasing	Presenting High Growth	Growth Slows Down	Decreasing
Operating Income	Negative	Low or Negative	Increasing	Increasing	Decreasing
Operating History	None	Very Limited	Limited	Useful for Valuation	Substantial
Comparable Firms	None	Some, in the same stage	Some, at different stages	Many, at different stages	Declining and mature
Source of Value	Entirely Future Growth	Mainly Future Growth	Partly Existing Assets and Growth	Mainly from Existing Assets	Entirely from Existing Assets

Table 1.1 – Main features of businesses during their life-cycle
Personal Elaboration from Damodaran (2010), page 8

Table 1.1 shows also the main difficulties a financial practitioner faces to determinate the economic value of a business: in the first stages of the lifecycle the firm has no history and high uncertainty, so its risk profile is very high, and its value is mainly based on future growth. When the firm and its industry mature, it becomes easier to forecast future perspective, to find out comparable firms and the weight of value created from future growth becomes smaller with respect to value arising from current business operations. In the last step, the decline, growth rate of revenues becomes negative, threatening the marginality and consequently the sustainability of the business. The main peculiarity of this stage is that "the firm does not increase the value of its economic capital, [which is destroyed and] the gravity of the decline is measured by the entity of this disruption in a certain time interval" (Giacosa & Mazzoleni 2012, page 15).

The business life-cycle model suggests also that in the long run the decline of a business, is "a normal phenomenon and sometimes recurring in the enterprise life cycle, caused by deterioration of its vitality". (Giacosa & Mazzoleni 2012, page 18) It follows that firms are asked to appropriately predict and defer the entry into decline by appropriately facing the external pressures coming from the environment: they "must learn to live with the risk of decline and crisis" (P. Evans in Guatri 1995, page 59).

When the decline occurs, the firm should immediately recognize it and accurately manage this event by exiting as soon as possible from stale Business Units and by finding new sources of value, to avoid the collapse of the firm and to transform the decline in a "rebirth", which is the renewal of the business and the restart of the process of value creation for all stakeholders.

1.3. DECLINE AND CRISIS

A business' decline is likely to be defined as a complex and progressive process characterized by a permanent reduction of effectiveness and efficiency of its operating dimensions: the business experiences a reduction in demand of good and services, together with increase of costs which reflects in reduction of operating marginality and cash flow generation, and they lead to the recognition of losses in the profit and loss statements. According to Giacosa & Mazzoleni (2012), a business experiences a decline whether operating margins and earnings, although they are still positive, they are shrinking over time and the reduction is expected to persist in future periods. It follows that we cannot talk about decline if reduction of earnings is caused by exceptional events and it is expected to quickly recover in the following years. Then, the only presence of extraordinary, transitory or purely cyclical losses shall not be classified into indications of decline.

At the light of complexity of decline, many academics affirm that this phase in the business' life-cycle should be divided into two main steps, which eventually, whether any recovery is not possible, lead to a final phase characterized by the definitive cessation of the firm's operating activities. According to Guatri (1995), the two steps of a business' decline are called *decline* and *crisis*, while the business dissolution is the *disarray.* Buttignon (2008), calls the steps, respectively, *potential crisis, reversible crisis* and *irreversible crisis.* Furthermore, Guatri divides the *decline* in two sub-phases, the *incubation* and the *maturation*. Analogously, the phase of *reversible crisis* may be staged into *financial tension* and *insolvency*.

Although the distinction between decline and crisis is not straightforward, and difficult to be practically disentangled, Sirleo (2009) provides an interesting definition of these steps. He suggests that decline is a physiological phase of business life-cycle, characterized by alternance of periods of decline and return to growth through restructuring interventions with limited external impact; while crisis is a deterioration of decline which appears irreversible, unless radical interventions involving external stakeholders are taken. Moreover, Giacosa &

Mazzoleni (2012) state that in some cases the decline is so rapid that the business immediately enters in a situation of crisis, being asked to take radical intervention for its survival.
According to a quantitative point of view, as suggested by Buttignon (2008), to distinguish different phases of decline, management should put its attention on present value of future cash flows that are expected to be generated by the firm. This value is known as *going concern value*, to underline the fact that it refers to the flow of revenues and operating margins coming from the continual conduct of core operating activities of the business. The *going-concern value* shall be compared with cumulated nominal value of outstanding debt (both financial and non-financial) and with estimated amount of proceeds from liquidation of all firm's assets, net of costs of disposal. When *going-concern value* is declining over time, but it remains higher then nominal value of debt, the business is facing a potential crisis; whether *going-concern value* falls below the cumulated amount of debt, the firm faces a situation of reversible crisis, which is likely to be solved through extraordinary measures. On the contrary, when g*oing-concern value* is lower than *liquidation value*, the firm faces a situation of irreversible crisis. In this case, the firm as a coordinated set of operating assets and resources is not valuable anymore: residual value of proceeds from separate disposal of assets owned by the firm, less the costs of termination of the activities, is higher than expected value of future cash flows. Figure 1.2 shows the relationship between *going-concern value, debt and liquidation value* in a distressed firm.

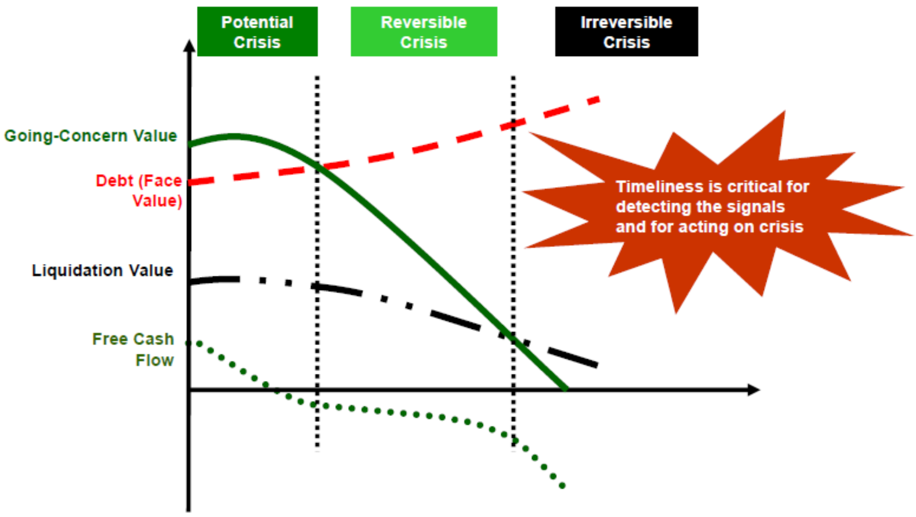

Figure 1.2 – Dynamics of Values in decline and crisis
Source: Buttignon (2008), Page 256

Despite this approach based on going-concern value is consistent with the final aim of a business, since "the Theory of Value Creation assumes as fundamental aim of a firm the increase of value of economic capital [and] this represents the condition to ensure the survival of the firm in the long run" (Falini 2011, page 8), the estimation of requested financial variables is not straightforward since it depends on many variables and on the personal valuation of the appraiser, so it is important to define these stages also from a managerial point of view.

According to Guatri (1995), the entry of a firm into the first stage of decline is usually gradual and progressive, but in some cases the trouble is fast and unexpected. A potential crisis can be discovered by its very first indications which have been called *decadence* and *disequilibria*: decadence mainly refers to quantitative symptoms of decline, while disequilibria are connected to quantitative indicators of decline.

Disequilibria and decadence are referred to inefficiencies in the internal management of the firm, which may or may not be influenced by the dynamics of macroeconomic factors or industry-related phenomena. While indications of decadence are constituted by qualitative and descriptive phenomena, such as resignation of key human resources, loss of productivity or conflicts with suppliers and employees, disequilibria refer to deterioration of measurable ratios, taken from financial analysis, and computed from the most recent accounting data and financial statements.

During maturation of decline, cash flows reduce over time and profit and loss statements close with losses, which start to erode the book value of shareholders 'equity. If the reduction is not transitory, the value of capital for debt and equity investors starts to be negatively affected, via expectations of lower cash flows and higher volatility in in revenues and marginality.

In the following step, the *financial tension*, the decline becomes a real but still reversible crisis, because the economic losses have a negative impact on the availability of cash. The firm is not able to match inflows and outflows of cash, and some payments are missed. Therefore, the firm starts to lose its creditability and trust among stakeholders, while its enterprise value continues to fall. This phase is very relevant because inevitably the state of distress become knowledgeable by the external stakeholders and their reaction may deteriorate the situation.

In the last phase, the firm in crisis has run out available financial resources, becoming unable to face any payment due and it must take radical interventions to come up with the crisis. The interventions affect first the management and the corporate investors, and then the other stakeholders who are asked to make very strong sacrifices. This is the phase of *insolvency,* which, as it will be explained and defined in Chapter 2, is very relevant also from a legal perspective, and it requires deep interventions that involve both capital structure and top management team. In this situation, the corporate stakeholders inevitable sustain sacrifices and losses because of erosion of cash flows and assets value.

The already described steps of decline are summarized in Figure 1.3, where the yellow boxes represent the state of *decline* or *potential* c*risis* and the blue boxes represent the state of *crisis*.

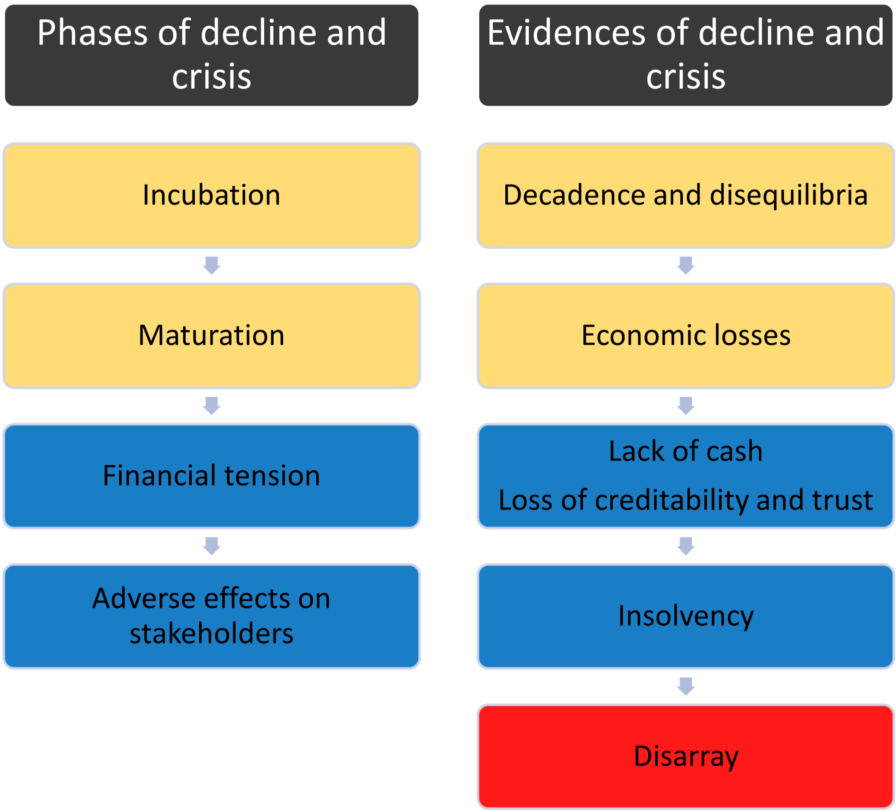

Figure 1.3 – Phases and Evidences of decline and crisis
Personal elaboration from Guatri (1995) – Page 112

1.3.1. Common features of decline

To summarize the main common characteristics showed by firms experiencing a phase of decline, Damodaran (2010) provides a list of features which are very likely to be found in businesses experiencing situations of decline and crisis:

- Stagnant or declining revenues, especially whether macroeconomic and industry situation is good or growing: this aspect directly refers to the above-presented definition of decline;
- Shrinking or negative margins: this phenomenon signals that the firm is losing contractual power towards suppliers and it is reducing selling prices to sustain reduction in revenues; it reflects to the second leg of definition of decline;
- Asset divestitures: some assets owned by declining firms lose their going-concern value, so they are likely to become more valuable inside different businesses, divestitures are also driven by the need of collecting liquidity to satisfy expiring obligations;
- Extraordinary dividends and stock repurchases: if the declining firm has limited room for growth and debt burden is sustainable, the combined effect of asset divestures and

existing operations may generate large amounts of cash which are devoted to shareholders;

- Downside of financial leverage: declining cash flow and limited growth opportunity determine the unsustainability of existing debt, since the hypothesis at the basis of the amortization plan of debts are not actual anymore. Therefore, the business faces difficulties in honouring payment of interests and in refinancing expiring debt.

1.4. METHODS FOR RECOGNITION OF DECLINE AND CRISIS

As suggested by Falini (2011), a situation of decline is manifested by the presence of economic losses and, in its deeper phases, also by the so-called *financial tension,* which is the temporary impossibility to meet the payments due on time. When the decline is not timely recognized by the managerial team, the only adoption of short-sighted measures to overcome losses and financial tension, such as the over-utilization of available revolving credit line, produces its effects in the very short run, threatening the whole equilibrium of the firm in a longer time horizon. In fact, when the dimension of the decline is not perceived yet by management, the decision-maker adopts these measures hoping that the financial tension is transitory, but in absence of a consistent action plan, the problems are bound to reappear with bigger dimensions. It follows that, to avoid the possibility that situations of decline and crisis are not tackled on time, determining further deterioration of the business' perspective and eventual entry in irreversible crises, it is important that the management team continuously monitors the most critical external variables and it adopts all available tool for timely recognition of decline.
Many scholars, such as Guatri (1995), Sirleo (2009) and Fedele & Antonucci (2015), distinguish the methodologies for recognition of decline and crisis into three categories:

- Methods based on intuition
- Methods based on financial analysis
- Methods based on models

In details, methods based on intuition are not based on formal procedures: the management team identifies the dynamics of most critical strategic and operating indicators of decline, according to personal experience and the business features, to judge the entry into a situation of decline. The indicators of decline selected by management may be qualitative, being closer to what Guatri called symptoms of decadence, or quantitative, revealing the presence of disequilibria. In every case, the number of possible indicators is almost infinite, to properly consider key factors and performance indicators which are specifically significant for a single firm.

With respect to financial analysis, it is the traditional methodology suggested by managerial science to assess indications of decadence and, especially, disequilibria typical of situations of decline. The manager is asked to compute the proper ratios based on data taken from financial statements and to compare them with both the historical dynamics inside the firm and with comparable firms. Unfortunately, it does not exist a table with universal benchmarks, so this methodology too is influenced by the personal interpretation of the analyst, together with issues related on reliability of input data. The main ratios are designed to investigate the business dimensions of profitability, level of liquidity and sustainability of the financial structure.

Reduction of profitability indicators, resulting from the reduction of demand and prices, result in a perspective lower generation of free cash flows which may result in a liquidity shortage. In fact, low availability of liquidity, measured through the Current Ratio (Current Assets / Current Liability), or more reliably through the Quick Ratio or Acid Test, which focuses only on assets eligible to be rapidly converted into cash, even if not accompanied by low profitability, requires the adoption of emergency solution to ensure the continuity of payments and to avoid further troubles on operations. Finally, the analysis of the financial structure, conducted though static ratios such as Debt / Equity or Debt / Assets and sustainability ratios such as Interest Coverage and EBITDA / Debt, allows to predict the capability of the firm to correctly repay its outstanding liabilities, in medium-long term horizon. If the financial structure shows disequilibria, the management team should plan and undertake the proper actions to timely reduce the debt burden and to avoid the entry into situations of insolvency.

Finally, methodologies based on models are aimed at overcoming the subjectivity of the financial statement analysis through statistic tools which try to combine financial ratios in a linear model which predicts the presence of situations of decline and distress and eventually its gravity. As an example, the model developed by Ohlson (1980), is a logistic model which linearly combines a set of nine financial ratios and binary variables in a numeric indicator (the O-score), as the input for the assessment of the business' probability of default. Details of the model are presented in Figure 1.4.

$$O_1 = \log \frac{Total\ assets}{GNP\ price\ level\ index} \qquad O_2 = \frac{Total\ liabilities}{Total\ assets} \qquad O_3 = \frac{Working\ Capital}{Total\ assets}$$

$$O_4 = \frac{Current\ liabilities}{Current\ assets} \qquad O_5 = \begin{matrix} 1\ if\ Liabilities > Assets \\ 0\ otherwise \end{matrix} \qquad O_6 = \frac{Net\ Income}{Total\ Assets}$$

$$O_7 = \frac{Funds\ from\ operations}{Total\ liabilities} \qquad O_8 = \begin{matrix} 1\ if\ losses\ for\ the\ last\ 2\ years \\ 0\ otherwise \end{matrix} \qquad O_9 = \frac{Income_t - Income_{t-1}}{|Income_t| + |Income_{t-1}|}$$

$$then\ \ p_d = \frac{e^{O_s}}{1+e^{O_s}}\ \ where$$

$$O_s = -1.32 - 0.407\ O_1 + 6.03\ O_2 - 1.43\ O_3 + 0.0757\ O_4 - 1.72\ O_5 - 2.37\ O_6 - 1.83\ O_7 + 0.285\ O_8 - 0.521\ O_9$$

Figure 1.4 – Ohlson model for estimation of Probability of Default
Source: Ohlson (1980)

1.5. CAUSES OF DECLINE AND CRISIS

After the top management team has acknowledged the actual presence of decline or crisis, the following step for a successful exit from the situation is the deep and sincere analysis of the causes which triggered that situation. Only the recognition of causes of decline permits an adequate comprehension of problems faced by the business, aimed at the adoption of a consistent plan of required interventions for operational and financial restructuring.

In the analysis of the causes of decline and crisis, academic literature distinguishes the subjective approach and the objective approach. According to subjective approach, the corporate crisis has been originated by incorrect behaviour of individuals operating with the business; it follows that, theoretically, the substitution of the individual responsible for bad choices with a new and more competent individual, is likely to ensure the resolution of decline and crisis. The responsibility for bad choices is usually found in key decision-makers: directors, top management and controlling shareholders, but in some situation key employees and even external stakeholders, such as banks, suppliers and trade unions who oppose the transformation of the business. (Giacosa & Mazzoleni, 2012 and Sirleo, 2009)

Under the objective approach, the crisis is caused by forces and events connected to the variability of the external environment, which is highly dynamic and turbulent. It follows that management team is continuously asked to control the most critical external variables which are likely to negatively affect the business' key success factors and sources of competitive advantage, triggering a situation of decline and distress. According to this approach, the variability of external environment, at macroeconomic, sectorial or individual level, may determine the following types of crises:

- Inefficiency crisis, when production and commercialization of goods and services are less efficient than competitors, determining unfavourable incidence of operating costs;
- Overcapacity crisis, when the demand of goods and services reduces, and the firm is not able to reduce its fixed cost in conformance to the new level of production;
- Decadence crisis, characterized by reduction of the spread between unitary revenues and marginal costs, impeding the coverage of fixed costs and non-operating expenses
- Crisis determined by lack of planning: the absence of clear targets and objectives to be reached by the organization and low investments in innovation produce low commitment of individuals
- Financial disequilibria: an imbalanced financial structure reduced profitability since it determines higher cost of capital with respect to comparable firms and unsustainable financial expenses in case of economic downturn and reduction of revenues. (Guatri, 1995)

Moving to the actual factors that give origin to a situation of decline or crisis, we refer to the study of Falini (2011), who classifies the multiple causes of crises into five macro-variables:

1. Corporate governance issues
2. Strategy management and planning
3. Operations
4. Macroeconomics and extraordinary factors
5. Industry-related causes.

Variables 1, 2 and 3 correspond to the causes of decline which refer to the subjective approach, since they belong to decisions and attitudes of people inside the firm, while the fourth and the fifth factor depend on the external environment and they are very difficult to be controlled and influenced by the firm.

In details, issues related to corporate governance refer to shareholders decisions and managerial choices, including the accountability of the entrepreneur and the top management. A situation of decline is originated by these issues when shareholders and directors are not adequate to face the complexity of the firm or they do not systematically act in the best interest of the firm. The corporate governance structure may be inconsistent with respect to the external environment, and it is likely causes the rise of moral hazard, which transfers wealth and benefit from the firm to the managers. In some cases, the firm may be damaged by the owner's decision of selling out its controlling stake, showing substantial indifference for the future perspectives of the firm,

or by the passage of the firm from the founder into the hands of his children and relatives.
The second variable, strategic planning issues, is connected to long-term view and to the effects of past choices, including decisions related to capital structure and to investments for growth and development. In fact, excessive access to debt financing exposes the organization to the risk of unfavorable evolution of exogenous variables, such as interest rates, threatening its future perspectives. Mergers, acquisitions and extraordinary operations are also potential causes of decline and crisis: weak strategic planning that misestimates the dimension of revenues and cost synergies and bad integration between acquirer and target affect the capacity of value creation.
With respect to Operations, the presence of higher operating costs then competitors and the inefficiency of internal processes are signals of weakness since they determine lower marginality and cash flows generation. The firm with higher costs (either fixed or variable) is more sensitive to external shocks and its profits are more likely to quickly become negative. The inefficiencies may be caused by lack of economies of scale, excessive diversification of business segments, inefficiency of internal processes and longer time needed to manufacture and deliver the product or service to final customers with respect to competitors.
Moving to the external dimensions of the causes of decline, the fourth group is related to the economic cycle and extraordinary events such as natural disasters or terroristic attacks. These factors impact a huge number of firms belonging to the many different industries, because they negatively affect the consumers' trust and their propensity to spend money. Macroeconomic risks affect also the volatility of commodity prices and foreign currencies, becoming likely to unpredictably affect the marginality of businesses.
Finally, with respect to Industry dimension, the decline can be driven by shifts in product life cycle, causing reductions in demand and need for consolidation of production capacity, or by technological disruptions that makes existing products obsolete and not complying with the customers' needs and willing. The reduction of legal and technical barriers in a sector (for example the expiry of patents and licences) and the entry of new competitors may cause an intense price war and damage incumbent firms which are not capable to quickly modify their cost structure.

1.6. TURNAROUND PLANNING

To exit from a situation of decline and crisis, managers are asked to implement what is internationally known as *turnaround,* a process characterized by radical changes, implemented in a situation of pressure due to the context of corporate crisis. These changes usually involve the key elements of a firm, such as its identity and culture. In *turnaround*, efforts and inevitable sacrifices borne by involved stakeholders are coordinated to achieve the common aim to overcome the decline situation and to return at economic and financial equilibrium on long-term view. During this attempt, controlling shareholders and incumbent directors usually leaves their position to new people who possess specific competencies and who encounter the favour of corporate creditors. (Guatri 1995).

Turnaround may start during the situation of decline or crisis, always reminding that the effectiveness of the process is higher when it starts in the earlier stages of decline. Whether the firm is in crisis, low trust and bad image negatively influence the process, requiring bigger and bigger efforts to return to value creation. The ideal impact of turnaround on value is presented in Figure 1.5.

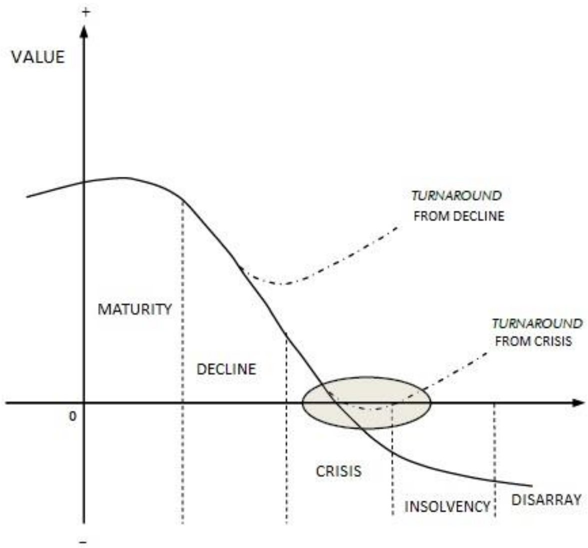

Figure 1.5 – Ideal impact of turnaround on Value
Source: Giacosa & Mazzoleni (2012) - Page 150

Despite the turnaround process of a firm in decline and crisis is unique and uncertain in its outcome, because each distressed firm presents specific asset base, valuable resources and causes of decline, Guatri (1995) asserts that this process follows a logical pathway that may be articulated in these phases:

1. Recognition of decline and adoption of the new leadership
2. Analysis of the situation and valuation of the available initiatives
3. Negotiations with stakeholders
4. Normalization of the business
5. Restart of value creation.

When the management recognizes that the firm is in an actual situation of decline, the first action to be done is the substitution of part or all the managers: in fact, the acknowledgement of the downturn is an implicit admission of managerial errors. The substitution of incumbent managers with external people constitutes an injection of credibility towards the involved stakeholders. The external managers, in fact, have a more objective view of the crisis and they can externalize all the possible risks and uncertainties, than they may take the decision with lower emotional bias and personal involvement.

To augment the probability of success of the turnaround all the components of the new management team should be assigned a clear role and the key decision should not be delegated along the managerial structure, but they should preferably be taken by a recognized "transformational leader" with the aim "to mobilize the organization to accept and work toward achieving the new vision, and to institutionalize the changes" (Tichy & Ulrich 1984, page 59). This leader must create, develop and communicate a new vision, and he is also asked to renew "the political and cultural system" of the troubled organization, by changing the feeling of human resources form losers to winners.

It is important that the turnaround process is planned in a formalized document, which resumes the causes of the decline, includes a photograph of the actual economic and financial situation expressed through accounting data, then it lists the interventions to be implemented to overcome the situation, the sacrifices requested to stakeholders and the projected financial statements that follow the adoption of extraordinary measures. The document should include an initial financial statement, which assumes the role of a reference framework for the valuation of the future result that will be achieved. This financial statement should include devaluation of useless past investments to be as more conservative as possible and to ensure the maximum level of transparency towards the stakeholders of the distressed firm.

Then, the core part of the document is the action plan, which should be logical and consistent, and it should show the importance and the effectiveness of proposed interventions for the resolution of the crisis, by convincing the reader that it is reasonable and achievable. When the turnaround starts from a complex situation of crisis, and the continuation of business is threatened by the absence of financial resources, the action plan may be composed by three different moments: the *emergency plan,* the *stabilization plan* and the *development plan.* The first is focused on the survival of the distressed firm, by immediately ensuring a positive cash flow. It is characterized by a situation of hurry and urgency and it is usually based on requests of bridge loans, speed divestitures and cost cuttings; its time horizon goes from two weeks to three months. This emergency plan is a few pages' documents, that it is integrated in the stabilization plan, which will be focused on the two following years and it is bound to re-establish the equilibrium on revenues and costs. The third plan is based on a three or four years' time horizon and on the creation of new value. (Giacosa & Mazzoleni, 2012)

1.7. STRATEGIC DECISIONS AND TURNAROUND IMPLEMENTATION

After the phase of negotiation with stakeholder and their consent, the managers have the possibility to implement the plan for the stabilization of the corporate situation, with the final objective to return to an acceptable level of economic profit (*id est* above the cost of capital).

In this phase the strategic decisions are taken at a business units level: for each segment of operation, the turnaround plan shall explicit if it is bound to be liquidated, divested or restructured.

This choice is subordinated to the objective to refocus the firm its core business, so areas where the firm has accumulated distinctive competencies and experience are deemed to be restructured, while accessory segments should be liquidated or sold to new owners able to create new values through operational and financial synergies. On the other hand, the decision is conditioned by financial constraints and the market constraints: the former may drive the decision of divesting an important business area because of urgent need for liquidity, while the latter may lead to the keeping of a secondary business unit due to a market downturn that makes impossible to close the dismissal at a fair price. As supported by Benson (2010), liquidation is the last resort option, applicable when the business unit is disarrayed and not capable to create substantial value through operating activities; furthermore, as it will be seen in Chapter 2, when assets are very specific for the business, it is difficult to create value through liquidation and the restructuring alternative becomes more valuable.

It is important to specify that if the firm is composed by a single business unit, as suggested by Buttignon (2014), the decision to restructure the business ensures the continuation of going concern together with the conservation of the control of equity in the hands of the incumbent shareholders. Whether the controlling shareholders does not possess the competencies and resources to ensure the return to a sustainable value creation, the divestment may articulate in the shift of the control of the business to stronger and more competent shareholders, or in the acquisition by another firm to create value through revenues and cost synergies: in the latter way the business loses its independence, keeping its operating activities as a branch of a bigger firm.

According to Guatri (1995), the interventions for revamping the operating activities are usually based on a mix of four alternatives: *restructuring, reconversion, rescaling and reorganization*. By restructuring, the firm improves the efficiency of transformation processes and reduces the cost incidence while keeping the same mix of products and markets. Through reconversion, the firm gradually moves from the current marketing mix, which is bound to be abandoned, to a new combination of innovative and more valuable products. Then, through rescaling, the scale of production activity is reduced, and many employees are laid-off to overcome a situation of overcapacity, typical when the crisis involves the entire industry because of the declining life-cycle of the output product. Finally, we talk about reorganization when the interventions are related to organizational aspects such as redefinition of functions, communications flows and production methods, together with the adoption of a new governance structure that allows the clearness of decisional processes and the supervision of the involved stakeholders.

During implementation of the turnaround plan, the organization passes a situation of instability due to disruption of routines and the reduction of employees. Therefore, the recovery of trust and collaboration with external and internal stakeholders, assumes a critical importance for the success of turnaround and the return to a new equilibrium on business operations. When the most critical phase of the crisis is passed, and the lack of liquidity is resolved, the firm needs to focus on investments in promotion and advertising of new and existing products to recover lost market shares, together with product innovation and development of equipment and human resources. These investments shall be careful and conservative to avoid the risk of bad investment which could cause another situation of crisis. When the situation of decline is passed, the firm has become more solid than in the past and it may implement a more ambitious strategy refocused on creation of value in the medium and long term. The consent obtained by external stakeholders to important investments, such as the acquisition of another firm is the signal that the crisis is passed, and the trust has been completely recovered. (Guatri, 1995)

Despite the managerial efforts for planning, negotiation and implementation of turnaround, its success is threatened by factors outside the managerial control. The empirical evidence suggests that a firm exiting from a turnaround needs to restart the process because the plan was not sufficient to sort out the crisis and to solve the financial troubles. In fact, Gilson *et al.* (1990) examined a sample of 169 attempts of restructurings in U.S. in the 1980s, where in 89 cases the first restructuring was unsuccessful, and firms needed to access to bankruptcy procedures to sort out the crisis. A similar study by Giacosa and Mazzoleni (2012), about Italian businesses which entered financial crisis in 2009-2010 states that, on 98 considered plans, 58 of them were being renegotiated because their objectives were not achieved. With respect to Italy, this high rate of unsuccess may be caused to the low commitment of the management, who sees the document as a formality to renegotiate liabilities and cut excess cost, rather than an occasion to shift the business strategy and revitalize the core resources and competencies. In fact, the authors assert that in formulation of the plan, management team does not put the necessary attention on the revenues side, since they rely on a generic recovery of the macroeconomic downturn. More specifically, these weak financial plans usually assume a conservative growth rate in the first two years, and a sudden acceleration of the growth in the following years, which is not supported by adequate strategy and implementation.

CHAPTER 2 – LEGAL FRAMEWORK TO SORT OUT FINANCIAL DISTRESS

2.1. NEED OF BANKRUPTCY LAW IN SITUATIONS OF INSOLVENCY

A firm that stays in a situation of *financial tension* or *insolvency,* defined according to Chapter 1, is facing a delicate situation from a legal point of view. This paragraph provides the legal definition of the state of insolvency, since this state opens the room for the application of legal rules about bankruptcy. According to Italian Bankruptcy Code (art. 5) "the state of insolvency appears through the default or other facts that show the debtor's inability to regularly satisfy its obligations". The *default* means the failure to perform contractual or legal obligations, typically the payment of a monetary amount within a certain expiry date, but also the delivery of a good, the performance of a service or the compliance with *covenants*, which are commitments towards lenders involving financial and cash flow management.

It follows that insolvency is the situation where the firm has already defaulted on a relevant obligation (under Italian law: valuable more than 30.000 Euro) or, at present, it is not able to pay the expiring debts on a regular basis, considering the anomalies in the means of payment or in obtaining the necessary amount of cash. Insolvency requires that the events of defaults must be proven and reasonably caused by the situation of distress, or that the firm stays in dangerous situations, classified by the law among "the other facts", where the entrepreneur has abandoned the firm, the assets have been carried away or the business premises are suddenly closed. (Cian 2014)

The presence of default or its threat jeopardizes the survival of the business and it may cause a situation of trouble among creditors, since they may activate the instruments for the enforcement of their right provided by the Civil Law. It follows that creditors, under the supervision of the Court, have the power to expropriate the firm's assets (real estate, equipment, inventory), to sell them in a public auction and to retain the proceeds from disposal until its credit is fully satisfied. This system does not fit for the insolvency of a typical firm for two main reasons. First, the firm is a dynamic system, where, on a day by day basis, goods are bought from suppliers, then flow through a production process and finally they are delivered and disposed to clients. In this sense, the expropriation of a production facility, a piece of office equipment or a substantial portion of goods on inventory may block the entire corporate activity; in this way the proceeding creditor is satisfied while the other stakeholders that obtain benefit from their contributions to the conduct of business are damaged.

Secondly, if we consider that the insolvent firm owes a substantial monetary amount to a set of different creditors, the situation becomes dramatic since ordinary enforcement law is based on *first come, first served* principle: the creditors who start the enforcement procedure later bear the risk that the available assets have been exhausted by the claimholders who had taken the enforcement action on a timely basis. It must also be considered that the law fixes the *par condicio creditorum* (Absolute Priority Rule – APR) principle, which states that more creditors with the same grade of priority, when they enforce their claim, have the right to share the proceeds from execution proportionally to the amount of their claim.

To complete the general framework, an important issue must be specified. Exceptions of the principle of parity and equal treatment of creditors are granted by priority rights whose source is defined by the law. If the creditor owns a preference right over its claim, proceeds from the enforcement of the credit are first retained by the preferred creditor until the claim is fully satisfied. After the satisfaction of the preferred creditor, residual proceeds are devoted to non-preferred creditors. Typically, preference rights are negotiated between creditor and debtor according to the mandatory legal provisions and they are constituted by pledges on assets and mortgages on real estate, that give a preference right limited on proceeds from the encumbered asset.

It follows that, when a firm negotiates debt financings, the lender poses a special attention on obtaining a set of preference rights and guarantees that ensure the satisfaction of its claim in case of default. Moreover, preference rights negotiated between lenders and borrower shall be combined with preference rights directly originated by the law (for example about wages to employees, taxes, professional fees) thus establishing a hierarchy of preference rights on the firm’s real and financial assets.

About debt financing, the highest level of priority is given to senior secured debt (where secured means guaranteed by real guarantees such as special privileges, mortgages and pledges), then unsecured debt has a lower level of priority, while junior or subordinated debt has the right to be reimbursed after all the debt claims. At the lowest level we find equity claims, which are the residual claims, and in a situation of insolvency, they receive a payoff equal to zero, or even negative in the case the firm is not granted the legal benefit of limited liability.

Therefore, under ordinary legal system, the only threat of a business' insolvency, causes the run of debtholders and suppliers to ask for new guarantees and to consolidate their position as soon as possible: suppliers ask to be paid on cash and they may refuse the delivery of raw materials, short term loans are revoked, guarantees are activated, and enforcement actions are taken. All these initiatives erode the amount of assets available for the continuity of the ordinary business activity and for the satisfaction of claimholders who do not promptly take legal actions versus the distressed firm.

Considering also that the activation of multiple enforcement procedures leads to the multiplication of legal and procedural costs, while increasing the uncertainty on the outcome, this messy situation opens the room for the need of an exceptional legal system regulating bankruptcies and corporate reorganizations, to sort out the overall problems of a distressed firm in an efficient, timely and equal way.

According to Buttignon (2008), corporate reorganization legal frameworks shall be declined into dimension of efficiency, timeliness and equality of the resolution of the situation of corporate crisis. Efficiency dimension refers to the principle that potential contribution to value creation of a resource is maximum weather the resource is devoted to its optimal use and it stays in combination with other valuable assets. So, an efficient reorganization framework should direct the decisions about the future utilization of corporate resources and assets (restructuring, transfer or liquidation) at the only aim to maximize the value created for all the stakeholders.

Timeliness assumes a key importance in the field of corporate restructuring, since a long situation of uncertainty deteriorates more and more deeply the image and reputation of the firm toward all internal and external stakeholders, reducing over time the value of intangible assets and resource, and therefore the Enterprise Value. In this sense “the principle of timeliness represents a declination of the efficiency dimension in a dynamic sense” (Buttignon 2008, page 246).

Then, the equality principle is related to the fair distribution of the restructuring costs and the sacrifices requested to stakeholders of the distressed firm. Given the fact that total value of assets is lower than the value of outstanding claims, the loss should be split among shareholder according to an equality principle.

Practically, principle of *par condicio creditorum* and strict priority rules, while they ensure fair distribution of losses, they do not guarantee full efficiency and timeliness, since they pose the incentive for opportunistic behaviour and further disruption of value. As it will be seen in Chapter 3, controlling shareholders, through directors appointed by them, own an informational advantage about the situation of distress and they also have a specific know-how for the diagnosis and resolution of the crisis: in this sense they are the best candidates to ensure best utilization of assets and the maximization of value. Unfortunately, according to the status of residual owners, they cannot enjoy the value created by their effort on restructuring until all debtholders have been completely satisfied, so they have the incentive to abandon the control of the firm. It follows that it exists a trade-off between efficiency and equality: whether the crisis is at early stage, it is reasonable to give incentives to the directors and shareholders in charge to quickly implement the restructuring. In this way the equality is violated, since shareholders receive some benefits, but maximization of overall Enterprise Value is ensured. As counterbalance, all the valuations about the equality and the reasonableness of a certain restructuring plan with respect to the creditors' interest should be reserved to creditors themselves, who have the right to receive transparent information on a timely basis.

Bankruptcy and corporate restructuring law, trying to reconcile the needs of efficiency, timeliness and equality, creates an exceptional regime, where the principle of *first come, first served* on the enforcement of claims leaves its space to collective and negotiated procedures. The system is usually completed by provisions that limit the power and the freedom of directors and top managers in a troubled firm, by including obligation of information and external supervision by the public authority. The limitation of power, enforced through criminal consequences in case of breach, is aimed at avoiding opportunistic behaviour that damages the corporate creditors.

Insolvency law is an institutional variable that is strictly related to various elements such as juridical tradition, attitude toward entrepreneurship, relationships among firms and capital markets, political considerations; the interaction of these forces creates characteristic practices for each country. For example, in the United States, the Bankruptcy Reform Act, in force since 1978, is based on two pillars: Chapter 7 and Chapter 11. While Chapter 7 refers to the compulsory cessation of the going concern of the business and the following liquidation of the corporate assets, Chapter 11 is the framework for the restructuring in continuity of the insolvent firm. These two pillars are related, since under a restructuring procedure, whether the agreement among parties is impossible to be reached, the restructuring plan is not feasible, or a situation of irreversible crisis is ascertained, the Chapter 11 is converted into a Chapter 7 procedure. The main features of the latter procedure are that the collection of outstanding claims toward the insolvent firm is stopped, the control of the overall firm is taken by a receivership whose activity is to sell out in a competitive auction all the assets of a firm, on aggregated or individual base, while resolving all the pending disputes. At the end of the liquidation, legal and administrative costs of receivership are paid, then net proceeds are distributed to claimholders according to a strict priority rule: a creditor belonging to a lower preference level cannot be paid unless the creditors of all the upper preference levels are fully paid; according to *par condicio creditorum,* the claimholders with the same preference right must be paid with same percentage on the nominal amount of credit. (Berk & DeMarzo 2011, page 545)

2.2. ORIGINS OF CORPORATE REORGANIZATION LAW

This paragraph focuses on the origins of corporate restructuring provision, which in multiple jurisdictions constitutes a feature of the insolvency legal framework aimed at increasing the economic efficiency in dealing with situations of decline and crisis. Baird and Rasmussen (2003) analysed the historical situation of most relevant distressed firms in the United States that led to the birth of an organic discipline for corporate restructuring. Nowadays these provisions are included, with modifications, into the actual Chapter 11 of the U.S. Bankruptcy Reform Act. Recently, Chapter 11 has become a point of reference for countries, such as United Kingdom and continental Europe, which historically focused their legislative *corpus* on the liquidation of the distressed firm and they have recently felt the need to regulate restructuring procedures.

It may be anticipated that "Chapter 11 of the U.S. Bankruptcy Code […] favours the reorganization and rehabilitation of all financially troubled companies that are deemed to be worth more as going concerns than liquidated in a piecemeal form, [while other countries] use bankruptcy for a different purpose: to liquidate insolvent businesses for the benefit of creditors, or to safeguard [...] the rights of workers and other non-financial stakeholders" (Gilson 2012, pages 25-26). For this reason, outside the U.S., the word "bankruptcy" is used as a synonymous of "business liquidation".

At the same time, in German and Japanese experience, public institutions in the field of corporate reorganization play a marginal role because corporate governance practices and dynamics between the firm and its stakeholders have produced long term-oriented relationships among stakeholders sustained by the reciprocal trust and transparency. In Germany, the firms strongly collaborate with their so-called *Haus Bank,* a bank with is the point of reference for every type of financial need. The relationship between bank and business is characterized by low level of asymmetrical information about the current and future perspectives of the business, determining the fact that, in case of corporate crisis, the *Haus Bank* is available to provide long term loans. Eventually, the bank converts the defaulted loans into equity, thus assuming the direct control of the distressed firm and then taking a key role in the restructuring. Similarly, in Japan, the commercial relationships between firms and bank are very stable and long-term oriented. Even, inside the bigger industrial groups, a banking division is included, which directly exchanges information with the directors of the interrelated companies and it provides a wide financial support. So, if a company of the group is distressed, the bank promotes the turnaround plan, by facilitating a wide consent among the involved stakeholders. Definitively, in the Japanese experience, the inclusion of a business into a big industrial group favours the contributions of the associated businesses entertaining commercial interrelationships for the resolution of a crisis, in compliance with the aim to preserve the value and the intangible resources for the overall group. (Guatri 1995)

Restructuring law was born in U.S. in the nineteenth century, where many railways were built and then exercised by private corporations which presented an operating profit, but they could not repay the debt issued to cover the construction costs. More specifically, the construction or acquisition of a portion of a railway line was financed by financial intermediaries through "multiple series of mortgage bonds secured by the portion of the line being built or acquired" (Bernstein 2007, page 9). Railways are assets with practically no market, so it was impossible to sell the line or a single stretch of it, to obtain the money needed to repay the bondholders. The components of a railway are also dedicated and specialized assets "put to their highest and best use": it is impossible to move the single components to another use without destroying a large amount of value. Consequently, investment banks and lawyers created a form of receivership aimed at restructuring the distressed firm with these key features: "a stay of the collection activity of creditors, the infusion of operating funds, and negotiations among representatives of the various debtholders over a new capital structure". (Baird & Rasmussen, 2003, page 759)

By contrary, at the same time in the England, the home of the first Industrial Revolution, many textile firms dominated the economy by employing many workers. Some textile mills were able to grow in scale and economic importance by acquiring other plants, while other factories were not successful and were shut down. In this industry, the capital required for the opening of a textile plant was relatively big, but it was affordable by a wealth individual investor of that time, without the need to access to capital market and to build complex financial structures. After the initial investment, the founder used the cash generated by the same business to sustain expansion and growth. Furthermore, the machinery was produced in a standardized way, it was available on the market and it could be adapted to the specific mill at a very low cost. Definitively, since the going concern value of textile plants did not depend neither on dedicated assets nor on qualified employees, and the amount of investment were relatively low, at that time in United Kingdom a set of provision on corporate restructuring was not developed, because it could not add efficiency to the economy. That is why U.K. insolvency law originally focused on liquidation rather than on going concern restructuring.

Therefore, we may state that corporate restructuring discipline is aimed to ensure an efficient utilization of the distressed firm's assets and it best fits for "large firms with specialized assets dedicated exclusively to them" (Baird & Rasmussen 2003, page 759), although, as already seen, during the Industrial Revolution they were not the typical firm in distress, but they were exceptional cases. Nowadays, the most relevant sources of a sustainable competitive advantage of firms rely on intangible assets, intellectual property and human resources. Firms with hard dedicated assets, such as power plants, coal mines or oil refineries, continue to exist, but they are declining in importance because of rising globalization and the commoditization of raw materials. The point is that, although some exceptions exist for very powerful intangible assets (for example a worldwide-known lifestyle brand or an innovative patent on technology),

intangible assets are exploited in the best way inside the unique mix of resources which contributed to its origination. It follows that intangible assets are very valuable from the originating firm's point of view, while outside of it they loss relevant part of potential for value creation, so they are bound to remain into its original organization to comply with the "best use" theorem. That is one of the reason why many countries, whose insolvency law was centred on liquidation, have recently amended their law to offer a reorganization option.
The definition of efficiency into corporate restructuring does not mean that dedicated assets should be rescued by sacrificing the interests of claimholders in every case: whether the highly specialized asset is not able to create a valuable stream of revenues, the institutional system should not permit the keeping of the assets into the going concern, but it must force its dismissal. Baird & Rasmussen (2012) provide two examples on this point: the customized set of warehousing and logistics facilities for Webvan, a company with the ambitious business to sell grocery products through on-line websites, and the telecommunication satellites for Iridium, a telephone company that wanted to provide international calls for mobile phones. These businesses did not encounter the favour of customers, so the companies did not recoup its costs and they fell into bankruptcy. The continuation in usage of these assets by the two distressed companies would have only destroyed value, therefore it should not be permitted by an efficient restructuring institutional system. In fact, it occurred that warehousing facilities of Webvan were dismantled and liquidated to recover its low residual value, while, about Iridium satellites, their costly periodic maintenance were stopped, and they naturally burned into the atmosphere. The conclusion it that, while "many assets work equally well in one firm as another, [in some cases] assets that are tailored to a specific firm may not represent a source of value but the source of failure" (Baird & Rasmussen, 2002, page 768), because of their high cost and the lack of marketability, so the distressed firm should abandon them as soon as possible.
At last, the need of regulation for corporate restructuring activities, is also driven by the difficulty in contracting allocation of control rights in eventual case of future distress, combined with the impossibility to take consistent decision without the pressure of the bankruptcy court. The point is that when the firm is in a positive situation, power stays in the hands of the shareholders who delegate power to directors and managers, but "when things are going poorly, control rights can shift to parties not traditionally viewed as inside the firm" *(Ibidem,* page 779). In fact, in case of insolvency, "creditors acquire control rights and may have the power to shut the firm down. It is the fear of improper exercise of such power that lies at the heart of reorganization law" *(Op. Cit.,* page 779*)*. So, in the case the investment agreements allocate control rights in the hands of someone who could take advantage from choices that do not increase the overall Enterprise Value by exploiting the uncertainty on the firm's future

perspective and the informational asymmetry, the need for corporate restructuring institutional framework takes origins.

To make an example, a controlling owner of a distressed firm, exposed with his wealth, who is granted the benefit of taking the first move in the restructuring process, may delay the recognition of the crisis by stating the situation will improve physiologically, thus continuing to destroy value for the other stakeholders. In the worst case, having nothing to lose, he may undertake fraudulent decision that lead to sharp reduction of cash flows and value. By contrary, a hypothetical secured creditor who is given a decision power over the distressed firm would reasonably decide a sale of its collaterals that ensures a quick and full recovery of its claims, although the more efficient choice is to wait for higher selling price that had benefited also other creditors.

Law of corporate reorganization is therefore aimed at giving the control power in the hand of the people who are in the position to exercise it in a qualified and efficient way, by reconciling the "mismatch between incentives of the individual investors that possess control rights and what is in the best interest of the firm as a whole". (*Op. Cit.,* page 781)

2.3. MAIN FEATURES OF CORPORATE REORGANIZATION LAW

After explaining the factors that driven the birth of corporate reorganization law, in this paragraph we describe its essential provision. The paragraph takes as model the Chapter 11, since, as previously seen, advanced financial markets in United States put the condition for the birth of institutions for reorganization. Legal provisions of Chapter 11 are exceptions to the ordinary principle of civil law and to the applicable framework in case of bankruptcy liquidation, which have been exported to many other countries in adapting their insolvency laws to the increasing needs for regulating the reorganization of distressed firm.

The most relevant legal aspects of Chapter 11, and more generally of corporate reorganization laws, are:

- *Automatic stay* provision;
- Access to super priority financings or *bridge financing;*
- Breach of executory contracts;
- Exemption from judicial review of the agreements in case of subsequent corporate crisis;
- Extension of the agreements to dissenting creditors.

The *automatic stay* provision is a legal instrument that becomes immediately active when the filing for Chapter 11 is presented to bankruptcy court by a distressed firm. This provision blocks all the enforcement action eventually proposed by the creditors, allowing the firm to continue the utilization its assets base during the whole restructuring procedure. By this way, the potential problem of the creditors' run to the enforcement of their claims is sorted out, since the defaulted creditors are put in a position of parity, obviously keeping unchanged the preference rights fairly obtained before the opening the procedure. As counterbalance, creditors are granted the judicial supervision on the ordinary course of the business and the approval by the court for each action that may violate the principle of equal treatment of creditors, such as the utilization of pledged assets or preference payment of relevant suppliers. A provision related to the automatic stay is the stop in the computation and accumulation of interests on unsecured financial loans, thus allowing the distressed firm to achieve an immediate benefit on cash flow and economic result. (Gilson 2012)

The provision on *bridge financing*, which under U.S. Chapter 11 is called Debtor-In-Possession financing, allows investors to give the distressed firm, and the firm to obtain, the so-called *new finance* or *fresh cash*, which constitutes an important source of "financial oxygen" to guarantee the continuation of the ordinary business activity in the emergency phase of the crisis. These new financings constitute a bridge loan since, when the agreement about the restructuring is reached, that source of finance is substituted by proceeds from dismissal of non-core assets, longer-term loans or infusion of new shareholders' capital, according to the content of the turnaround plan. U.S. bankruptcy law gives to credits from Debtor-In-Possession financing a top priority right with respect to claims of all other creditors, so they shall be fully satisfied, and they rank before the debt pre-existing at the opening of Chapter 11 procedure.

Another key provision is the possibility for the firm to demand the bankruptcy court resolution or breach of unfavourable executory agreements in force, despite their original expiration date. The legal clause is very useful for the renegotiation of leasing agreement and other long-term contracts whose original clauses have become unsustainable for the distressed firm and they have contributed to the causation of the insolvency. In fact, if the judge approves the resolution of the agreement, the counterparty has the right to receive an indemnification for damages whose priority level is equal to ordinary unsecured creditor. Therefore, since this provision allows the transfer of wealth from the contractual counterparty to the distressed firm, it favours the renegotiation of the original agreement with the aim to rebalance the reciprocal obligations and to obtain a mutual benefit. (Gilson 2012)

With respect to the exemption of judicial review, a brief explanation is needed. Whether a firm stays in a situation of irreversible crisis and it is bound to be liquidated under the supervision of the bankruptcy court, the bankruptcy receiver reviews all the anomalous operations undertaken by the firm, such as preferential payments or assets disposal at very low price with respect to market value and he takes a *clawback* action. It means that anomalous business operations which damaged the creditors' interests, and especially *par condicio creditorum* are declared invalid, and the counterparty is forced to return all the considerations received by the distressed firm related to that transaction. The exemption under analysis applies to the insolvent firm which takes extraordinary operations and preferential payments previously included in a legalized reorganization procedure and then it is subsequently forced to liquidation. In this case, the bankruptcy court of the latter proceeding, does not review the measures undertaken by the firm in compliance to the former restructuring agreement, although they had caused an actual damage on creditors' heads, and they would in principle had been subject to clawback actions. Finally, the extension of the effects of the restructuring agreement to the dissenting creditors is a common legal effect of reorganization procedures undertaken under the judicial control. At the end of the procedure, in the case the level of consents over the restructuring plan has reached the majorities prescribed by the applicable law, the bankruptcy court formally approves the agreement which becomes binding for all the impaired creditors, independently of their actual vote in the public hearing. The creditors who did not vote are assumed to have approved the proposal, while the creditors who rejected the proposal have the only possibility to open a proceeding for challenging the plan. In the case a rejecting creditor proposes a challenge, the bankruptcy court assesses the fairness and the equitability of the restructuring plan by a formal estimation of going-concern value and liquidation value. Then the court ascertains whether "the market value of new securities distributed to each class under the plan at least equals what the class would receive in a liquidation" (Gilson *et al.* 1990, page 318), which is the most relevant limit imposed by the law in the formulation of the debt restructuring proposal and in the assignment of the new claims. Therefore, if the plan has been judged "fair and equitable", the court rejects the opposition proposed by the dissenting creditor, who is therefore entitled to receive the impaired considerations according to the legalized restructuring plan: this is the so-called *cram down* power.

2.4. COST OF REORGANIZATION PROCEDURES

All restructuring procedures involve time, professional effort and formal steps, inevitably producing the distraction of economic resources from the ordinary business conduct to the extraordinary reorganization. Restructuring costs belong to the costs of distress and they constitute relevant factors for any valuation about the efficiency of a certain reorganization strategy. Cost of distress are defined as "any economic losses that are attributable to the adverse impact of the restructuring on the investment decisions and the operations of the business". (Gilson 2012, page 26). On this point, scholars have traditionally classified the costs of distress into two categories, direct costs and indirect costs.

The former category includes all the out-of-pocket expenses connected to the negotiation and the realization of the restructuring plan, such as legal fees, administrative expenses, professional fees for accounting and valuation experts, financial advisory fees, eventual cost of consultancies in the creditors' interest sustained by the firm.
The latter category is determined by the loss on trust and the adverse effects on commercial operations that are caused by the situation of distress and the following attempt to exit. According to Berk & DeMarzo (2011) and Gilson *et al.* (1990), some determinants of indirect costs of distress are:

- Loss of customers, due to the uncertainty on the continuity of the business activities and the risk the firm will not perform the obligations on pending contracts;
- Loss of suppliers, who fear their credit will not paid: legal rules on preferential payment of strategic suppliers under in-court restructuring may reduce the incidence of this cost;
- Loss of employees: the situation of insolvency may cause the resignation of the key human resources;
- Loss on trade receivables: some customers defer or miss the payment of receivables, on the assumption that the distressed firm does not have the resources to control the collection of credits;
- Lower proceeds from divestitures: the firm cannot negotiate a fair value on the dismissal of non-core asset because of the public knowledge of the situation of crisis;
- Inefficient investment: procedure management may undertake investment which destroy economic value and delay the liquidation of an inefficient business;
- Adverse effect for creditors: a firm's bankruptcy may contribute to the financial distress of the businesses with a relevant exposure toward those firm;
- Value of the management's time spent into dealing and negotiating the restructuring;
- Missed investment opportunity that were not undertaken because of the situation of distress.

Both categories of costs of distress have a negative impact on the Enterprise Value and they reduce the recovery of creditors' claims, so a rational debt investor should subtract the expected value of the costs of distress when they compute the net present value, and therefore the initial investment, of a loan or bond financing.
While journalists and scholars put their attention on the amount of direct cost of restructuring, the effect of indirect cost on enterprise value, is usually very relevant. The attention on direct costs is highlighted by the fact that, under judicial procedures, its amount shall be public, and each payment of professional and consultancy fees classified among this class must be ly approved by the bankruptcy court. However, the empirical analysis of Gilson *et al.* (1990), has

stated that mean and median cost of restructuring the public traded debt through an exchange offer is very trivial. In fact, with respect to a sample of U.S. firms that were restructured in the 1980s, the mean amount of direct cost of restructuring divided by the book value of asset had been close to 3 %. According to Gilson (2012), "direct costs are relatively small after adjusting for a company's size" (page 26) and they are characterized economies of scale, since they have higher incidence on smaller firms. For example, the famous bankruptcy of Lehman Brothers, sorted out through a Chapter 11 procedure, presented an amount of 1,6 billion dollars of direct costs, which corresponded to the 0.25 % of the assets and to 0.5 % of the amount of liabilities asked by creditors.

With respect to indirect costs, although they are difficult to be precisely determined, the impact on Enterprise Value is more relevant, since their estimates "range from 10 % to 25 % of firms' stock market before bankruptcy" (*Ibidem*). Furthermore, a study by Andrade & Kaplan (1998) focused on a sample of 36 firms whose distress was primarily caused by the presence of a high level of leverage, states "the changes in operating performance suggest that the net costs of financial distress are no greater than 10 percent to 20 percent of initial value" (page 1463). Also, the study, through the application of an EBITDA multiples model, estimates that the losses of value determined by financial distress have a median value of 22 %, if adjusted for the industry performance, and 25 %, if adjusted for market performance; at the same time average loss have been determined respectively equal to 19 % and 23 %. Considering that these values are likely to be overstated because the performance of some firms belonging to the sample was affected by adverse economic downturn, and other twenty of them experienced an exceptionally good industry-adjusted return after the exit from Chapter 11 procedure. Finally, since it is not possible to completely disentangle the contribution of high leverage from the effects of economic adverse shocks on the quantitative performance of the distressed firms, the above presented estimates should be interpreted as upper limits of the cost of financial distress.

2.5. OUT-OF-COURT RESTRUCTURING

Although in-court procedures of restructuring or liquidation seem to be the natural room for sorting out situations of financial distress while ensuring efficiency and equality of the procedure, directors and management have the alternative to proceed with a private restructuring. Under a private restructuring, also called *workout* on an informal basis, the court is not involved, so the directors' power is not officially supervised by an external authority and limited by special legal constraints.

In order to choose the proper way of restructuring, directors and shareholders of a distressed firm should make a careful comparison of benefits and costs of both methods and then implement the alternative which is expected to bring a favourable agreement with stakeholder while minimizing the direct and indirect costs of distress.

The main feature of a private restructuring is that the overall process of reorganization, from the disclosure of distress to the approval of the agreement, is guided by the intentions of directors and the contractual power of the counterparties; by consequence the distressed firm's directors have the faculty to choose the most relevant stakeholders to be involved into the restructuring and conduct the negotiations with good level of confidentiality. Although the managing power is not constrained by insolvency law provisions, creditors may ask the appointment of external consultants and auditors as precondition to initiate and conduct the reorganization. Negotiations among stakeholders are centred both on "how the company should be valued, how much debt there should be, how the equity should be split" (Moyer *et al.* 2012, page 68) and on the extraordinary measures to restart the creation of new value, declined both on new sources of revenues and on reduction of outstanding costs.

This type of restructuring is fully regulated by private agreements between the distressed firm and their creditors, which, in case of reciprocal consent, realize the refinancing of claims through modification of the original terms of the debt obligations. It follows that none of typical effects of the in-court restructuring procedure is automatic and they must be separately negotiated with the creditors.

First, the *automatic stay* is not granted, therefore the firm is exposed to the risk that the creditors involved into the negotiations of the restructuring, after having assumed the information about the severity of the crisis, adopt an opportunistic behaviour by undertaking those enforcement actions that, as already seen, threaten the business continuity, the equal treatment of creditors and increase the incidence of procedural costs. Furthermore, liabilities toward claimholders excluded from negotiations must be fully paid according to original contractual expirations, and the same rule applies towards creditors who abandon the negotiation or does not agree with the final term sheet. To limit the adverse effect of the opportunism during the negotiations, since they may jeopardize the success of the reorganization and the continuity of the business, the distressed firm, when it acknowledges the situation of crisis, should ask creditors to provide a moratorium agreement to ensure a fair and ordered conduct of the negotiations. The moratorium temporarily stops the faculty to undertake enforcement actions on defaulted debt and on accumulated interests; then, in the case the private restructuring is successful, the frozen debt will be settled according to the final term sheet, which will be written and approved by the parties in compliance with the applicable law.

Secondly, under private settlements of corporate crisis, in the case the distressed firm needs bridge financing, the situation is quite difficult to be sorted out. In fact, the firm can access to new debt financing only without altering the position the existing creditors: therefore, either the bridge loan is negotiated to be more junior with respect to existing debt, or the senior creditors voluntary renounce to their priority rights. However, the former operation is costly for the distressed firm in terms of new financial expenses and it leads to high exposition to default risk by the lender, while the consent on the voluntary subordination of outstanding debt is likely to be rejected by the senior creditor.

Then, with respect to parties who dissent on the negotiated outcome of the private restructuring, from a juridical point of view, the content the final term sheet is not applicable to them, so they retain the right to demand the payment of the outstanding obligations according to the original agreement. It is important to underline that the possibility of full repayment of the obligation excluded from the impairment is allowed by the reduction of the debt burden due to the approval of the restructuring agreement, since under the adverse hypothesis that the restructuring was not undertaken, the firm would be forced to declare the bankruptcy. (Cian, 2014)

Also, as it will be seen later, a framework constituted by private restructuring arrangements without automatic binding effect for rejecting counterparties opens the room for the holdout problem, which may affect the success of the overall procedure in a relevant way.

Moving toward the technical aspects, the private restructuring requires the presence of qualified legal, accounting and business assistance: usually the intervention of a consultancy firm specialized in resolution of corporate crises coordinates the negotiation with stakeholders and it puts in place the necessary action for the achievement of consent and the formalization of the restructuring plan. Private restructurings are perceived to be less costly than judicial reorganizations, because the latter are strictly regulated by formal constraints, such as the need of opinions from independent professionals and the continual oversight by expert appointed by the court on the day-by-day management. These formalities affect the amount of direct cost of restructuring: according to Gilson *et al.* (1990), "when debt is restructured privately, legal costs are reduced because [extraordinary business] decisions can be made more quickly" (page 319); furthermore, the compensation scheme of bankruptcy practitioners gives them the incentive to prolong the time length of the procedure.

By contrary, a relevant positive aspect of private restructuring procedures is the confidentiality of the process: the negotiation and the implementation of the restructuring may remain covered by secrecy, being acts of internal management. Through workouts, only the stakeholders directly impacted by the turnaround plan are precisely informed about the actual situation of the firm: this strategy is reasonable if the crisis is not severe and it is likely to be completely sorted out by the negotiated reorganization measures. In the case of maximum secrecy, some relevant stakeholders, not directly involved into the restructuring, completely ignore the existence of a corporate crisis, thus preserving the relationship of trust and the corporate image. Confidentiality ensured by workouts avoid the diffusion of wrong information among stakeholders that would cause panic and sudden alterations of the normal core business activity, thus augmenting the severity of the crisis, or they would increase the complexity of the private settlement of crisis because of the need of including more counterparties.

Recently, the innovation of the *pre-packaged bankruptcy* in the United States has changed the dichotomy in the choice between private and judicial restructuring. The institution matches the positive aspects of both procedure, while limiting the cost and the time required for the resolution of the crisis. It consists in a restructuring plan privately negotiated between the distressed firm and its stakeholders, with a formal solicitation for their votes. Then the firm files for Chapter 11 submitting the bankruptcy court the restructuring plan already approved by the creditors. In this way, the distressed firm "reduces the amount of time [spent] in bankruptcy court, lowering direct and indirect financial distress costs" (Gilson 2012, page 30). In this way, the application of the Chapter 11 majorities for the approval of the reorganization prevents the undesired consequences of holdout problem in the phase of negotiation, thus facilitating the approval of a fair and equitable restructuring measures.

2.6. POSITION AND INCENTIVES OF STAKEHOLDERS

After the presentation of the main features of in-court restructurings and workout procedures, some considerations about the choice of the best strategy for dealing with corporate crises shall be made. Although the decision-makers should focus their attention on the interest of the overall mass of stakeholders, by adopting the solution which is more likely to be successful in sorting out the distress while minimizing the incidence of related costs and the consequent loss of Enterprise Value, the actual selection of the restructuring strategy and the resulting outcome of negotiations are biased by personal incentives and by asymmetrical information.

Unfortunately, it must be considered that each involved stakeholder takes its decision he is in charge to make by comparing the personal payoff of each available alternative considering as last resort option expected proceeds in case of liquidation, rather than the interests of the firm as a unitary system.

Starting the analysis with the profile of the shareholders-owners of an insolvent firm, first of all they evaluate the situation of the firm within the perspectives of its industrial sector, then they either feel that "the very fact of insolvency means that [they] have lost their economic stake" (Bernstein 2007, page 8), or they may judge their option value attached to equity is still positive, because of volatility of current assets due to uncertainties in its value and the presence of good future investment opportunities. In the former scenario the old shareholders do not invest new

money in the company and they pass their power to creditors filing for an in-court procedure, while in the latter they attempt a voluntary restructuring aimed at receiving a certain number of shares in the reorganized business corresponding to their option value of equity. Furthermore, they are interested in private restructurings whether expected costs are lower than expenses for judicial procedures. In the adverse case the mass of stakeholders does not approve the plan, owners have the incentive to delay the restructuring and hope for a recovery of the economic condition, otherwise they file for Chapter 11 (Moyer *et al.*, 2012). On this point, private restructurings are less likely to be successful since they affected by adverse selection problems: according to Gilson *et al.* (1990), "rational creditors are aware of the stockholders' incentives to misstate the value of the firm", so they prefer the immediate filing for an in-court procedure.
With respect to distressed firm's creditors, they have different schemes of incentive depending on the nature of their claim. Although they differ in intensity, all of them are encouraged to free ride the restructuring, thus determining the rise of holdout problem. In fact, a rational debtholder who is asked a voluntary impairment of its claim, compares the payoff of its available alternatives (accept or rejects): if he accepted, he would bear a loss equal to the impairment, otherwise, if he rejected, and under the hypothesis that all other debtholders accepted, he would be fully paid. It means that in case of individual rejection of the proposal, restructuring costs, in the specific dimension of the impairment of the defaulted claims, would be sustained only by the debtholders who accepted the proposal. The consequence of multiple rejections is that the level of consent over measures of debt renegotiations needed to overcome the situation of insolvency is not reached and the restructuring will inevitably fail.
Therefore, distressed firm's directors must anticipate the adverse impact of the holdout problem both in the choice of the restructuring process which is more likely to be successful, and in the formulation of the final proposals on debt restructuring, by including in the term sheet the proper incentives to favour the desired level of consent over the plan.
According to Gilson *et al.* (1990), holdout problem constitutes a relevant threat for a positive outcome of debt restructurings under private proceedings, especially where debt claims are spread among many small investors, such as public traded bonds. In fact, for public traded bonds, any change in the core term of the indenture (the term sheet regulating the features of the bond loan) must be approved by every investor. Practically, the acceptance of the restructuring on a bond loan is asked through a formal exchange offer, where the firm proposes their investor to voluntary tender their old bonds and he is given new bonds with lower nominal or coupon value. To minimize the holdout problem, the success of the exchange offer is conditioned to a minimal *quorum* of acceptance by bondholders, computed on the nominal value of securities, and the rejections are penalized: "the new bonds are generally more senior,

and mature sooner, than the old bonds" (Gilson 2012, page 323). Furthermore, holdout problem is also relevant, and interest toward private reorganization is reduced, in case the firm owes a relevant amount of trade payables toward many different suppliers. In fact, commercial liabilities are originated by a wide and varied set of contractual relationships, thus making impossible to use the technique of the exchange offer to achieve the consent on the restructuring. From the suppliers' point of view, their main interest, rather than the full recovery of their receivables, is the assurance on the continuity of the commercial relationship. Therefore, whether the distressed firm does not get liquidated and it involves the specific supplier in the future business activities at favourable conditions, its consent on restructuring is more likely to be obtained. (Bernstein, 2007)

By converse, private restructuring is likely to succeed when most of debt is held by banks, since financial institutions are particularly willing to settle a private restructuring. The predominance of the bank debt in the financial structure of the distressed firm causes positive externalities for the other involved debtholders: financial companies have a strong incentive to monitor the management and the results of the business, thus reducing the level of information asymmetry and the connected adverse selection effect.

Summing up, the intensity of the holdout problem may explain the fact that probability of success of a private restructuring is negatively correlated to the overall number of creditors who take part to the restructuring, while it is positively correlated to the percentage of outstanding debt toward banks and financial institutions (Gilson *et al.,* 1990)

When the high incidence of holdout problem determines the impossibility to reach an agreement, the only solution is the access to Chapter 11 protection, where the legal extension of the reorganization plan to dissenting creditors works in favour of a positive outcome of the negotiations. Practically, in Chapter 11 procedures, after the formulation of the reorganization proposal, impaired creditors are grouped in homogeneous classes with respect to the origin of their credit, the priority level, the presence of guarantees, and they are asked to vote for the acceptance or the rejection of the plan in a public hearing. The compulsory application of the agreement to all claimholders and the limited room for legal challenge reduce the possibility of free riding, since if the majority is reached all creditors bear both the benefits and the costs, while in case of rejection the restructuring fails, and the firm is forced to be liquidated.

Beside the holdout problem, another factor that affects the success of a private restructuring is the complexity of the financial structure. The contemporaneous presence of junior and secured creditors in the negotiations, together with physiological uncertainty on Enterprise Value, undermines the probability of obtaining a successful restructuring plan. In fact, these groups of creditors have opposite interests in the fixation of the reference value of assets and they will

compete for the control of the restructured firm by trying to obtain an equity interest in the restructured business. Subordinated creditors are interested in arguing the amount of the Enterprise Value is higher than the amount of debt owed to senior creditors: in this manner senior creditors are fully repaid, then junior creditors' claims are restructured partly in cash or debt and partly through the issuance of new shares, with their potential for unlimited capture of all the value created by future improvements of business activities.
On the other side, the senior but unsecured creditors have the incentive to set an Enterprise Value slightly lower than the debt they are entitled to receive: in this case their financial rights become the "fulcrum securities" and the creditors will obtain a relevant equity stake over the new firm. At the top of the capital structure, secured creditors, whose collateral value is higher than the amount of debt, are not affected by the restructuring: they will receive the full amount of both in the restructuring and in the liquidation of the firm. (Moyer *et al.,* 2012)
By contrary, the external supervision of independent practitioners and powers owned by the judicial authority allows distressed firm to reduce its liabilities to a more sustainable level. On this point, an empirical study based on a sample of 108 United States-based firms presenting a situation of distress due to high leverage, states that, while the level of "leverage remains high after both out of court restructuring and Chapter 11 reorganization, […] it remains much higher after out of court restructuring" (Gilson 1997, page 162). The study has found a positive correlation between nominal amount of pre-restructuring liabilities and debt resulting from the reorganization for restructurings undertaken out of the courts, while this correlation has not been found in the sample of firms which restructure their debt through a Chapter 11 procedure. Therefore, Gilson states that in workouts, the presence of transaction costs limits the reduction of debt, while in Chapter 11 they "do not appear to be a major deterrent to reducing debt". (*Op. Cit.,* page 163) This fact is due to some positive features of the judicial procedures, such as minimization of the blocking power by dissenting creditors, facilitation of assets sales and mandatory disclosure of the relevant information about business perspectives.
To complete the framework about the position and interest of stakeholder, it is important to specify the role of incumbent shareholders and directors in the approval and implementation of restructuring. As already anticipated, they are granted the right to take the first moves for the restructuring by officially declaring the state of crisis, then have the power to propose a solution to conduct the negotiations. To ensure this advantage is exploited in the best interest of the firm as a unitary entity, it is important to provide within the plan some considerations to these categories, notwithstanding their responsibility in the causation of the crisis. In fact, directors and managers in charge will put their maximum effort in the turnaround process if their rewards are conditional to the result of their actions.

With respect to former shareholders of the distressed firm, while the economic value of their equity stake is practically lost because of the insolvency, they continue to retain the corporate governance rights that the Business Law ensure to them. More specifically, operations that affect the property structure of the firm, such as increase in shareholders' capital through issuance of new shares, realized through a fresh cash injection or the equitization of defaulted liabilities, must be expressly approved by the incumbent shareholders also under in-court restructuring procedures pending. Since the lack of their approval blocks the resolution of the crisis, it is reasonable to sort out the deadlock by giving them a small equity stake as reward for their consent on the entry of new shareholders and the resulting shift of control. By consequence, although this solution violates strict priority rules in the attribution of the restructured firm's financial claims, turnaround plans usually reserve a small equity stake, to be issued in the form of shares or warrants, to the former shareholders of the insolvent firm and to the top management team who will negotiate and then implement the turnaround plan. (Moyer *et al.,* 2012)

2.7. DEBT AND EQUITY AS OPTIONS

To better understand the complex relationships among shareholders and claimholders, Resti & Sironi (2007) provide a useful insight about the financial situation of a business that falls into insolvency. They refer to the paper written by Merton in 1974, who applied Black & Scholes (1973) valuation model of option, to the valuation of corporate debt and contingent claims.

The model assumes, as simplifying assumption, that all corporate liabilities are represented by single zero-coupon bond with a fixed maturity (that may be assumed equal to weighted average maturity of existing debt), and that a company is in default when asset value is lower than nominal value of its liabilities. Since corporations are granted the legal benefit of limited liability, equity owners are not asked to personally repay corporate passive obligations, so they simply declare the state of insolvency and they leave assets in the hands of creditors. It follows that the profile of shareholders' payoff as function of the Enterprise Value is equivalent to the payoff profile of a long position on a call option: in case of default equity holders get nothing and they simply lose their initial investment. Otherwise, whether the overall value of corporate assets is higher than debt, equity holders exercise the call option by repaying the debt and retaining the differential between Enterprise Value and face value of debt, with a potential upper unlimited payoff.

By contrary, in the case assets value is lower than amount of debt to be repaid, shareholders does not exercise the option by passing the control of corporate assets to owners of debt claims. In this way, debt-financers' position may be viewed as a short position on a put option, since in

the case the debt is repaid, their payoff is upside limited to the face value of debt, while in case of default, they receive the full amount of the Enterprise Value, losing the differential between Enterprise Value and the value of the contractual repayment of debt.
To apply Black and Scholes model for options, the underlying asset is assumed to be the comprehensive set of corporate assets, while strike price is the amount of debt to be repaid at maturity. After these specifications, payoff profiles of debt and equity claims may be resumed in Figure 2.1.

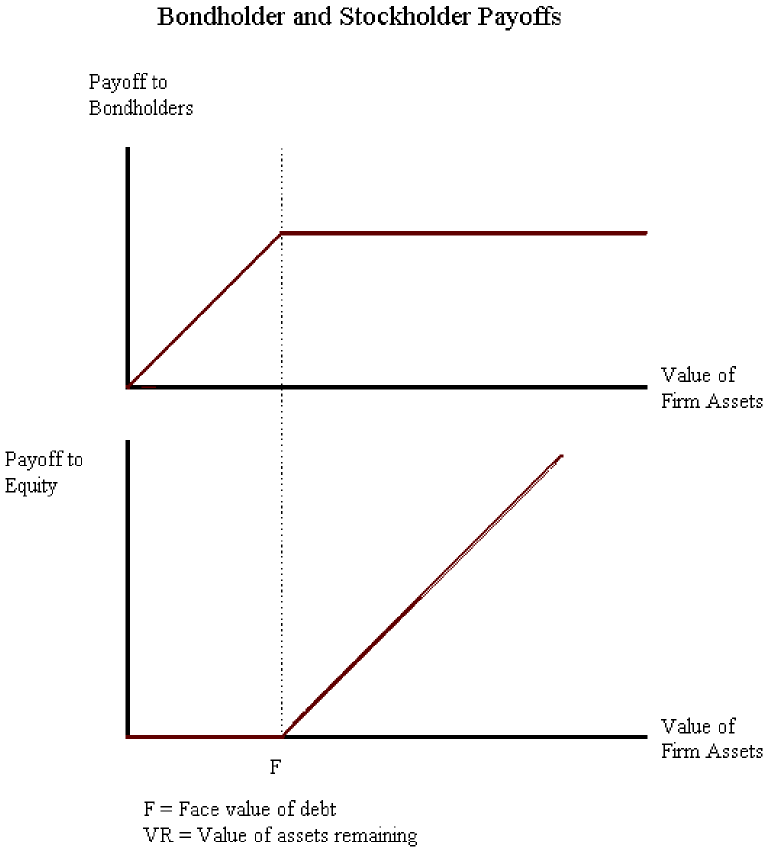

Figure 2.1 – Payoff of debt and equity
Source: http://www1.udel.edu/Finance/dandeli/FINC851/lectures/l4/img00001.gif

Moving from theory to practice, the shift of the control rights from equity holders to creditors is triggered by the opening of the insolvency proceeding, since the bankruptcy judge, the receivership and the appointed consultants start to work in favour of the mass of creditors. After the default, creditors are given the power to take decision about the technique for sorting out the crisis: reorganization, sale of the unitary business or separate liquidation of the assets. In case of sale, a third party acquires the control on the business' assets, while the creditors' rights are limited on the cash proceeding from the sale. In case of reorganization, after the completion of the procedure, the creditors become the new owners of the firm and they have the right to decide the destiny of the operation. Nowadays, reforms of bankruptcy procedures have determined that the options of reorganization and sale have become closer, since the creditors seem to play "the same role as shareholders of a solvent enterprise – that is retaining the company or selling it, whichever they perceive to be to their greatest advantage" (Bernstein 2007, page 8)

Furthermore, the view of debt and equity as option allows the exploitation of Black and Sholes model for computation of option value, which may provide useful insights for the determination of the value of outstanding debt and equity in the case the firm is in a situation of decline and crisis. The relevant variable of this model is volatility in the market value of corporate assets (and therefore in the Enterprise Value): high volatility, due to uncertain perspectives of recovery of the business or, more broadly, of the industrial sector or the overall economy, generates a positive value of equity although analytical Discounted Cash Flow models state that present value of current assets and future assets is lower than outstanding liabilities. The reason is that high volatility generates positive equity value "because of the time premium on the option (the time until the bonds mature and come due) and the possibility that the value of the assets may increase above the value of the assets may increase above the face value of the bonds before they come due". (Damodaran 2010, page 406)

2.8. DEBATE ON RESIDUAL OWNER IN DISTRESSED FIRMS

Some scholars have pointed out that conflicts among owners and creditors belonging to different priority levels, and consequent difficulty in the formation of decisions are due to the lack of a residual owner in situations of distress. They consider the fact that, when the firm is in a positive phase, the institutional provision about the power to take strategic decisions in the head of directors appointed by the shareholders guarantees the overall creation of value. In fact, shareholders assume the role of residual owners, defined as the "persons whose interests are identical with those of the firm as a whole" (LoPucki 2004, page 1342), since both positive and negative effects of their decision affect their wealth via the modification of value of their shares. From this consideration, it was proposed that decisions concerning debt restructurings and allocation of property rights in the new business should be taken by stakeholders who are directly affected by the consequences of their choices. Unfortunately, when the firm is distressed, the presence of multiple classes of claimants and uncertainty on value create difficulties in the identification of the residual owner. In fact, both shareholders and creditors are affected in the opposite directions by decisions taken by the management of a firm close to insolvency, generating conflict of interests and failure of this theoretical governance approach. The empirical study of LoPucki (2004) based on a sample of 98 U. S. public companies which exited from Chapter 11 in the 1990s has found that only in the 38 % of cases it was possible to identify a single class of investors as residual owners after the confirmation of the respective reorganization plan. In the other 62 % of the sample, the position of residual claimants had been shared by two or more different classes of investors. In these situations, the conflicting position of stakeholders may create difficulties in the arrangement of a governance scheme which ensures that the economic incentives of the decision makers are aligned with the interests of the entire firm. Therefore, the legal framework should provide a system of duties and fines to improve the efficiency of the procedure and to avoid the threat of liquidation of businesses which are still valuable as going concern. Under the assumption that it is possible and straightforward to identify a residual owner, in LoPucki opinion, the approach toward the residual owner should be used in a negative way: "the bankruptcy system should identify those who clearly and obviously are not residual owners and deny them […] representation." (LoPucki 2004, page 1364)

By converse, the study by Rasmussen (2004) states that the current practices for redefinition of property in distressed firms work quite well, since creation of new value is mainly achieved after the restructuring. He observes that, pending the reorganization proceeding, the actual control on business conduction is taken by senior creditors through the veto rights on relevant transaction and on the appointment of key managers. Also, the possibility for senior creditors to receive both debt and equity securities in the restructured firm gives origin to an incentive scheme similar to the position of a residual owner. Furthermore, although conflict of interests for residual owners belonging to different priority levels supposed by LoPucki are not shown to affect the investment policy of the firm, "conflict disappears (or at least is greatly reduced) by the end of the bankruptcy proceeding" since "after the case is over, both groups of erstwhile debtholders will be shareholders, at that time, they want to maximize the value of equity". (Rasmussen 2004, pages 1461-1462) It follows that conflicts among claimholders are focused on determination of the firm's residual value; at the end of the case all new shareholders, although belonging to different classes, have the incentive to work together to improve value of their shares through good investments in new projects.

Moyer *et al.* (2012) suggest the approach of the *fulcrum security*, defined as "the last creditor tranche or group that receives anything in the restructured firm", by consequence "the owner(s) of this tranche of securities tends to gain control of the restructured firm's equity through the restructuring process" (page 60). With the help of this definition, the residual owner may be defined as the category of debtholders who receives a controlling stake of equity in exchange for old claims because of the combined effect of low Enterprise Value and the application of priority rules in the restructuring. At the end of the reorganization, that specific category of claimants keeps the control over the business and it becomes the new residual owner. As it will be seen in Chapter 3, fulcrum security approach is largely used by distress investors, who acquire the control of declining firms by buying the defaulting claims and playing an active role in the negotiation process.

2.9. CORPORATE REORGANIZATION LAW IN ITALY

Focusing on the institutional environment in Italy, it must be specified that Italian Bankruptcy Code is historically focused on the liquidation of the disarrayed firm, being in this sense quite similar to the situation described by Baird and Rasmussen (2002) about the United Kingdom. The insolvency was viewed by the lawmaker as an infective disease, so Bankruptcy Code was aimed at the shutdown of the firm to avoid propagation of distress to related businesses, and to severely punish the failed entrepreneur. In fact, insolvency law used to be focused on the safeguard of the creditors' interest for the recovery of their claims, rather than on incentivizing the preservation of the residual value of the business through an effective turnaround process. (Giacosa & Mazzoleni, 2012)

In the recent years, under the pressure of increasing globalization, evolution of financial markets and modifications of competitive strengths, a series of reforms have taken place. As a result, now the institutional system considers the corporate crisis a normal situation, thus providing to distressed firms the instruments to restructure its claims while preserving the continuity and the residual value of the business; it also allows the entrepreneur in good faith, to close its insolvent firm and eventually to restart a new experience, having abolished any limitation of personal freedom after the closure of the procedure.

Italian Bankruptcy Code regulates two types of judicial procedures: bankruptcy liquidation *(fallimento),* addressed to the businesses staying in irreversible crisis; and composition with creditors *(concordato preventivo)*, for the resolution of the crises, both reversible and irreversible, with the consent of debtholders. Furthermore, insolvency law provides two instruments for the legalization of the out-of-court debt restructurings: certified plan *(piano di risanamento attestato)* and approved restructuring agreement *(accordo di ristrutturazione dei debiti omologato).* These legalization instruments, guarantying the existence and the fairness of a restructuring plan, incentivizes its adoption and the obtainment of consents over it because of these main legal effects, which are produced in various intensity:

- Exclusion of clawback actions for acts, payments and issuance of guarantees undertaken in execution of restructuring plan;
- Exclusion from criminal provisions for actions connected to the implementation of the plan in case of subsequent failure;
- Block of current and future enforcement actions undertaken by defaulted creditors;

- Mandatory extension of the content of the restructuring agreement to dissenting and non-participant creditors.

In this paragraph the main features of the institutions are now described, starting from the certified plan, with its low impact on business conduct but with low protective effect, to the bankruptcy liquidation, characterized by the interruption of the business and high pervasiveness of the judicial intervention. Beside these institutions, Italian framework provides a special legal discipline for restructuring and recovery of the biggest distressed firms. This special discipline gives origin to procedures of extraordinary administration of big distressed firms, characterized by intervention and supervision of both judicial authority and political authority (the Ministry of Economic Development).

2.9.1. Certified plan

The certified plan, regulated by article 64, paragraph 3, letter d) of Italian Bankruptcy Code, is a document elaborated by a distressed entrepreneur, containing the actions to be implemented for the achievement of "restructuring of the debt" and "restoration of the equilibrium in the financial structure". The plan must be accompanied by a report written by a Chartered Auditor and Accountant, independent from the distressed firm, where he certifies that data included into the plan have been verified by him and that action plan is feasible and aimed at the resolution of the crisis. The professional is directly appointed by the entrepreneur and its judgement must not be compromised by personal or labour relationships with the business and with any subjects interested in the restructuring, moreover the law expressly requires he did not work in the interest of the firm for five years preceding the appointment for certification of the plan.

The nature of the actions contained into the plan is various and it goes from measures for reduction of the financial burden, such as rescheduling of reimbursements, renegotiation of loans, write-offs of liabilities, to extraordinary operations on capital or dismissal of assets and business units. To be complete and consistent, the content of the plan shall include the hypothesis and assumptions at the basis of the proposed action, then it shall highlight the overall capability to produce positive economic results and subsequent cash inflows in a level sufficient to ensure the equilibrium with cash outflows, including the positive impact of the obtainment of new financings. (Giacosa & Mazzoleni, 2012)

The only formality, beyond the attestation of feasibility by the independent auditor, required for the validity of the certified plan is the presence of certified date on the document, to ensure the plan had actually been written before the implementation of restructuring actions and to avoid abuses. Therefore, certified plan is a unilateral act of the entrepreneur, it is neither subjected to approval by creditors, nor to judicial control, not even to compulsory disclosure of information

or publication. Despite the content of the legal provision, usually the intention of writing a certificate plan and its content are shared with the most relevant stakeholders and with subjects directly involved into its implementation, after a proper negotiation and informal consent.
Certified plan is bound to produce its effect only in case of subsequent insolvency and after the opening of a bankruptcy procedure: in such a situation acts, payments and issuance of guarantees undertaken in execution of the plan are legally exempted from clawback actions taken by the receivership. The application of certified plan has limited room in case of deep and complex crises because the law does not require any type of judicial approval after the formation of the certified plan. Therefore, scholars point out the risk that the bankruptcy court, in case of subsequent insolvency of the firm, carefully examines the documents and then it declares the plan not suitable to consent the restructuring of the debt and to re-equilibrate the financial structure. It follows that in these situations the court have the power to disqualify the certificate plan, so it does not grant the benefit of exemption from clawback and it allows the bankruptcy receivership to nullify also actions taken in execution of the certified plan, causing uncertainty about the actual degree of protection given by this legal instrument. (Sciuto, 2009 and Sandulli, 2006)
Furthermore, it must be specified that the voluntary publication of the certified plan in the Business Register allows the distressed firm to obtain some fiscal benefits: the exclusion from the taxable income of the extraordinary proceeds from write-offs of liabilities in the head of the distressed firm and, similarly, the fiscal deduction of impairment of claims in the head of creditors. (Alletto, 2014-15)

2.9.2. Approved restructuring agreement

A more sophisticated legalization instrument is the approval of restructuring agreements regulated by article 182-bis and following of the Italian Bankruptcy Code. The procedure requires an agreement between the distressed firm and its creditors, in a minimum share of the 60% of the value of outstanding claims and is constituted by the external control of the agreement which activates the protective effects guaranteed by the legal rule. Like the content of the former tool, the agreement must be addressed to restructuring of debt, to be undertaken in various ways, from rescheduling of existing debt to contribution of fresh cash in the form of equity or bridge loans. Differently from the certificate plan, the provision puts a special attention on the treatment of creditors excluded from the agreement: the firm shall provide evidence that the implementation of the agreement will supply the financial resources necessary to the full satisfaction of the excluded creditors within 120 days from the approval. About the external controls, an independent auditor, who is nominated by the firm in compliance with the above-mentioned provisions about certified plan, must provide the certification on accuracy of corporate data, on the feasibility of the agreement and on the expectations of complete satisfaction of excluded creditors. Then, the firm formally asks to bankruptcy court the approval of the agreement, which shall be accompanied by the certification of the auditor and by a set of documents about the actual economic and financial situation, the detailed indication of corporate assets, debts, guarantees issued and rights possessed by third parties. After the opening of the file at the court, the agreement shall be published in the Business Registry: from the moment of publication the law provides the automatic block for 60 days of all enforcement actions toward the distressed firm. The bankruptcy court, after the verification of the regularity of the documentation, approves the agreement, thus producing these effects:

- Continuation of the automatic stay for 120 days from the approval;
- Exemption from clawback actions on acts, payments and issuance of guarantees planned in the agreement, in case of subsequent bankruptcy;
- Exemption from criminal fines in case of subsequent insolvency limited to the content of the agreement;
- Preferential reimbursement of debts for loans undertaken in the form of "new finance" at the end of an eventual bankruptcy procedure.

To avoid the adoption of opportunistic enforcement measures by creditors, the firm may also anticipate the activation of the automatic stay, providing the bankruptcy court evidence about the ongoing negotiations. In this case the firm shall file, within 60 days, the approval of the agreement resulting from the negotiation or it may request the opening of the procedure of composition with creditors.

So, it is possible to point out that the approval of the restructuring agreement is an out-of-court instrument for the restructuring of distressed firm, with an intervention of the court limited on the formal aspects which gives stability to the content of the agreement. The legal stability of the agreement limits the holdout problem by favouring the creditors' participation to the agreement. In fact, creditors classified as excluded from the agreement, although they hold the right to be fully paid, face difficulties in taking enforcement actions and in asking for bankruptcy liquidation whether they payment does not occur; finally, in the adverse hypothesis the subsequent bankruptcy is opened and proceeds form liquidation are distributed, non-participants are given a lower payoff than participants because of the safeguard of acts implemented under the framework of the restructuring agreement.

2.9.3. Composition with creditors

Composition with creditors is regulated by article 160 and following of Italian Bankruptcy Code. According to Cian (2014), the institution allows a distressed entrepreneur to submit to his creditors a proposal for partial or deferred satisfaction of their claims, while keeping the managerial power over the firm. In case of acceptance by creditor and subsequent judicial approval, distressed firm's liabilities are limited to the content of the proposal and the exceeding obligations are definitively written off.

After an eventual temporary block of enforcement actions, the so-called phase of *concordato con riserva,* which may be asked by the firm through a specific petition to bankruptcy court, the opening of the composition with creditors is reserved to the initiative of the distressed firm's directors. They shall present to bankruptcy court the restructuring plan containing the proposal for the settlement of crisis, together with detailed documentation about corporate assets, outstanding debts and preference rights, guarantees and other rights possessed by third parties. The firm shall provide bankruptcy court a report from an independent auditor which certifies the accuracy of the corporate data presented in the plan and the feasibility of proposed actions. After the filing, the bankruptcy court nominates the delegated judge, the judicial supervisor *(commissario giudiziale)* and it calls the involved creditors in a public hearing. Pending the composition procedure, directors shall provide periodic information to the court and they shall ask the court's authorization for preferential payments and business actions over a relevant amount or classified into extraordinary administration acts. The supervisor oversees actions taken by directors, having in each moment the power to propose the court the stop of the procedure and the opening of a bankruptcy liquidation. He also informs corporate creditors about the existence of the procedure, through a written report about the causes of the crisis, the feasibility and the features of the proposal of composition, then he formally calls creditors at the hearing for the approval.

The legal provision grants the freedom about the specific content of the proposal: on one hand the firm may simply propose deferred or partial reimbursement of distressed debt, or liquidation of corporate assets; on the other hand, it could formulate more articulated solutions. In fact, the proposal may be based on contribution of assets to a new company, the merger of distressed company with another legal entity, and the subsequent satisfaction of creditors through the destination of shares or other securities issued by the resulting company. In these situations, the shareholders' meeting of distressed firm shall approve the issuance of new shares or the extraordinary corporate operations before the formalization of consent by creditors, then the execution of the operation is deferred after the judicial approval of the composition. (Palmieri, 2009) Other available solutions may involve third parties as providers of real or personal

guarantees for the settlement of the crisis: a peculiar situation is the commitment undertaken by an external assignee (in Italian: *assuntore*) to assume business assets and to repay connected liabilities in conformance to the proposal of composition.
With respect to liabilities owed by the distressed firm, the proposal may group the creditors in classes composed by homogeneous claims and position, then the firm may differentiate the treatment offered to each class. On this point, the formulation of the offer is subject to some legal constraints according to article 160, to avoid that the formulation of proposals alters *priority rules.* The partial satisfaction of preferred claims has been admitted by reform of Insolvency law in 2005, thus facilitating the adoption of this legal tool by distressed firms, but the proposal shall ensure that “the percentage, time and guarantees of the final settlement shall not be lower than those offered to creditors belonging to a lower priority level”. (Cian 2014, page 458) Preferred creditors shall be offered at least a sum equal to proceeds that are likely to be obtained in case of forced sale of their encumbered assets, by considering their actual level of priority together with the liquidation value estimated by an independent expert. Part of preferred claim higher than value of the encumbered assets is allowed to be partly repaid, but, for this portion, the preferred creditor “shall be offered something more of what is devoted to creditors originally belonging to a lower preference level, although not everything available”. (Cian 2014, page 458)
To approve the proposal, creditors may express their vote in the specific public hearing or by correspondence, considering the clause that if they do not vote there are computed among favourable. The proposal is approved whether it receives the absolute majority of positive votes computed on the monetary value of claims. In case creditors have been grouped in different classes, the approval of the proposal requires, together with the majority of overall value of claims, the majority of separate approvals by classes: each class is considered to approve the composition if it obtains the majority of positive votes by claimholders included in the class. Then, more than half of impaired classes shall approve the composition.
The effect of creditors’ approval is that all liabilities originated before the opening date of the procedure, shall be settled according to the content of the proposal of composition, which expresses percentage of reduction of the credit, new expiry dates, and eventual deferred payments or non-monetary settlements. This modification of original claims affects also creditors who dissented at the call for votes and tort claims which have not been already quantified in monetary terms. By contrary, all claims originated after the opening of the composition are not affected by any impairment or rescheduling and they shall be fully paid within their contractual expiration; however, they are granted the benefit of preferential satisfaction in case of subsequent insolvency. Dissenting creditors have the only right to file for

opposition to the bankruptcy court: the judge accepts the opposition only in case the creditor provides evidence that the satisfaction offered through the composition is lower than proceeds he is deemed to obtain after a bankruptcy liquidation.

Since procedure for composition with creditors is quite rigid, the institute has traditionally been used for the liquidation of the corporate assets, to take advantage from its lower pervasiveness than liquidation under bankruptcy. Nowadays, the 2012 reform has explicitly ruled the composition under going concern *(concordato in continuità),* ruled by article 186-bis of Italian Bankruptcy Code, thus introducing into Italian legislation an institution inspired by U. S. Chapter 11. The new provision is applicable whether the plan is based on continuation of the business activity or on the transfer of all or part of the business to other legal entities. In this situation, distressed firm shall provide a specific certification of an independent professional who declares that the keeping of the going concern allows the better satisfaction of the creditors' interests with respect to the liquidation.

In line with the U. S. discipline, under composition with creditors, distressed firm may ask judicial permits aimed at the obtainment of new financing necessary to ensure its survival or at the termination of unfavourable executory contracts. In the unfortunate case of subsequent bankruptcy, occurred during the composition of after its approval, the actions formerly authorized by the court or in execution of the approved plan are exempted from clawback actions.

While the reform makes the composition under going concern a useful instrument of the recovery of situations of distress, Giacosa & Mazzoleni (2012), observed that its application had been rare. Although their paper was published short time after the reform, they point out that its adoption is not favoured by creditors, since composition is thought to present higher impairments of claims than the restructuring agreement. Also, despite the provision on preferred reimbursement, internal procedures widely spread among banks prevent the supply of financings to firm under composition, thus limiting the adoption of this instrument for sorting out the crises.

Since 2015, the legislator has disincentivized the use of composition with creditors for the liquidation of the firm, providing the compulsory minimum recovery of 20 % of the distressed claims owed toward non-preferred creditors. (Odcec Treviso, 2016)

2.9.4. Bankruptcy liquidation

The last resort solution for situations of distress is bankruptcy liquidation *(fallimento).* After a petition submitted by the firm itself, by a defaulted creditor or by the public persecutor, the court ascertains the state of insolvency and therefore it declares the bankruptcy. The entrepreneur loses the administration of its assets and personal goods (situation called in Italian *spossessamento*), which pass under the control of a lawyer or chartered accountant nominated by the court, the bankruptcy receiver. All the debts and preference rights owed by the distressed firm shall be verified by the receiver and approved by the judge after a specific petition from the creditor, then the requests which pass the verification are included in a specific list of admitted claims *(stato passivo)*. The receiver arranges the dismissal of corporate assets through various techniques: as unitary complex or in atomistic way, by public auctions or competitive procedures, trying to maximize proceeds from forced liquidation. He also safeguards the residual interests of the insolvent firm through various powers: to collect outstanding receivables, to close pending contracts and litigations, and to take clawback actions for acts and payments which caused a damage on the position of the creditors and were undertaken in the year before bankruptcy declaration. Cash collected through the liquidation, net of the procedural expenses and professional fees, is intended first to preferential claims originated by the provisional going concern or by previous attempts of restructuring (approved restructuring agreements or composition with creditors), then to preferred claimholders in strict conformance to the hierarchy of priority rights; the portion of preferential claims exceeding the proceeds from liquidation of their encumbered assets is disqualified from priority and treated as unsecured claim. Finally, the residual cash is distributed to non-preferred creditors in proportion of the nominal value of their original claim.

While the state of bankruptcy implies the cessation of the going concern and the mandated liquidation of the assets withheld by the entrepreneur, bankruptcy law allows the provisional continuation of the going concern *(esercizio provvisorio)* whether it ensures the better satisfaction of creditors. In fact, continuation of the going concern may be useful to preserve value of goodwill and intangible assets, which would be suddenly destroyed in case of abrupt interruption of all business activities. The receivership values the opportunity and asks the authorization to the court, which is released for a defined period and it is subjected to the consent of the creditors' committee. In this case, the receiver has the power to directly manage the firm, and the resulting new liabilities will be repaid with preference, or he may lease the business to third parties. Anyway, this exceptional tool is functional to the realization of the going concern value through the disposal of functioning business unit in the hands of an acquirer, and in the case the going concern leads to a dangerous consumption of financial resources it shall be immediately ceased.

Another possible outcome of the bankruptcy procedure, alternative to the forced liquidation of asset and distribution of proceeds according to strict priority rules, is a negotiated settlement of the crisis called in-bankruptcy composition *(concordato fallimentare)*. It consists by an

agreement aimed at debt restructuring and creditors' satisfaction, with better recovery of distressed claims than the expected result from the planned bankruptcy liquidation.
This procedure may be initiated by a creditor, a group of them or by a third party as external guarantor, only after the approval of the list of admitted claim. The failed entrepreneur, instead, has a restricted time window to eventually advance a proposal of agreement, since the law wants to incentivize the composition of situation of decline and crisis thus avoiding the opening of bankruptcy procedure. Analogously to the composition with creditors, the practical realization of in-bankruptcy composition is not constrained by the law, so it may be constituted by partial repayments of creditors, transfer of the firm to creditors, or interventions by third parties as guarantors for the satisfaction of creditors.
The proposal of agreement shall be submitted to bankruptcy judge, who verifies its fairness with the support of the receiver and the creditors' committee. In case of admission, creditors are informed about the content of the proposal and they are asked to vote for the approval. Then, after the approval by the majority of unsecured and impaired creditors, the bankruptcy court definitively approves the composition. The approval of the composition produces the closing of the bankruptcy procedure without liquidation and dissolution, so corporate assets and administration powers on the firm are retransferred from the receivership to the entrepreneur. The entrepreneur is therefore obliged to repay its bankruptcy liabilities in conformance to conditions and percentages negotiated in the composition, and he is freed from the repayment of the exceeding parts.

2.9.5. Extraordinary administration

Under Italian law, situations of distress regarding more relevant firms are sorted out through a special insolvency procedure called "extraordinary administration of big firms in crisis". The institution is regulated by Legislative Decree 270/1999, and, according to article 1, it is aimed at "the preservation of productive assets through continuation, reactivation of reconversion of business activities". It means that the procedure is oriented at safeguard of production and employment levels, together with interests of creditors. Firms are eligible to access to extraordinary administration whether they are in situation of insolvency and they meet the following requirements: they have more than 200 employees and the overall liabilities exceed the 66 % of both the book value of assets, as in the balance sheet, and the revenues level in the last year.

The procedure starts from the declaration of insolvency by the bankruptcy court and the appointment of a judicial supervisor *(commissario giudiziale)*. The supervisor shall ascertain the possibility of the return of the insolvent business to a situation of economic equilibrium: whether the recovery is possible, the powers pass to an extraordinary administrator *(commissario straordinario)* appointed by the Ministry of Economic Development, otherwise the procedure is converted into an ordinary bankruptcy liquidation. The biggest firms may enjoy a special procedure regulated by Legislative Decree 347/2003 ("Parmalat insolvency decree") which allows them to avoid the phase of preliminary valuation, submitting to the Minister and to bankruptcy court a petition for the immediate opening of the extraordinary administration.
In both cases, the management powers over the firm are taken by the administrator and he is given the right to unilaterally cause the termination of disadvantageous pending contracts. Then, the administrator shall prepare a program aimed at either the restructuring and recapitalization of the distressed firm or at dismissal of business units to third parties, which is subject to the approval by the Minister. The administrator remains in charge also for the execution of the approved program. Pending the procedure, going concern of the business is maintained, eventually liquidating or ceasing the non-core and unproductive activities, and credits arising from the continuation of the business are satisfied with priority.
With respect to the liability side of the insolvent business, all enforcement actions are blocked; the verification of claims and the distribution of proceeds originated from the dismissal of assets and business units follow the rules of bankruptcy liquidation, except for the possibility for suppliers and employees to receive anticipated payments. Alternatively, the extraordinary administration is also likely to be settled toward creditors through a composition proposed by the insolvent firm or by a third party.

2.10. CLASSIFICATION OF ITALIAN LEGAL TOOLS

Buttignon (2016) proposes a classification of instruments for resolution of financial distress provided by Italian bankruptcy law according to two dimensions: confidentiality of the crisis versus strength of the solution. Confidentiality dimension refers to the level of information that the business is obliged to give to external stakeholders in compliance with the legal discipline: disclosure of information is very low for certificate plan, while it gradually increases for procedures characterized by intervention of the judicial authority. The dimension of strength is connected to the intensity of the main legal consequences of the instruments, and it is summarized in Table 2.1.

	Certified plan	Approved restructuring agreement	Composition with creditors
Block of enforcement	No	Yes	Yes
Exemption from clawback	Medium	High	High
Exemption from criminal fines	No	Yes	Yes
Binding of dissenting creditors	No	No	Yes

Table 2.1 – Legal effects of Italian Bankruptcy Law Institutions
Personal elaboration from Cian (2014) and Buttignon (2016)

From the joint analysis of the two dimensions, Figure 2.2 shows a positive correlation between the strength of the effects produced by the above-mentioned legal instrument and the intensity of their impact on external stakeholders of the distressed firm.

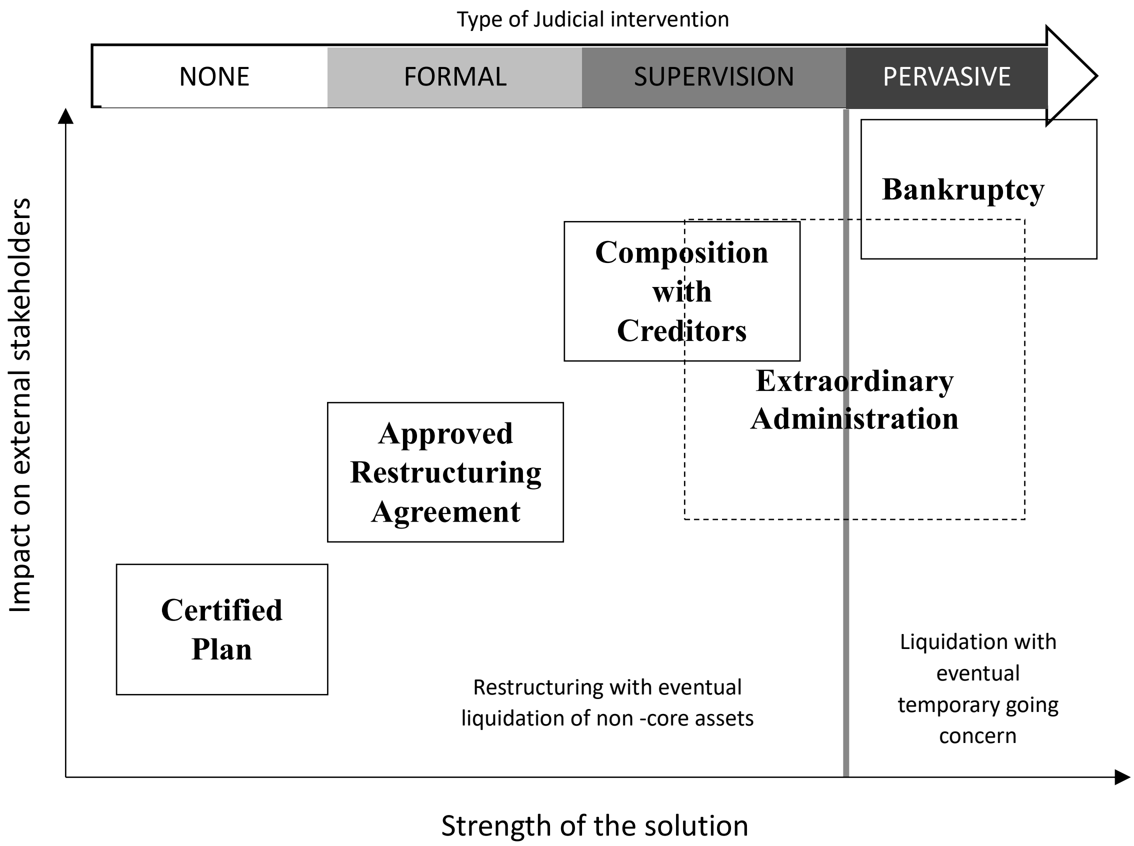

Figure 2.2 – Strength, external impact and judicial intervention of Italian Bankrupty Law institutions
Personal elaboration from Buttignon (2016)

Moreover, Giacosa and Mazzoleni (2012) have developed a matrix tool aimed at suggesting the appropriate legal tool for the formalization of the restructuring plan. It considers, on a dimension, the depth of the situation of financial distress and the correlated intensity of sacrifices requested to creditors, while the other dimension refers to commitment of involved stakeholders to support the restructuring.

In case of low intensity of the crisis, the risk of subsequent bankruptcy is remote, so if the support by stakeholders is low, the restructuring plan should be legalized either through the

certification *ex* article 67 or through the judicial approval *ex* article 182-bis, to show the credibility of the plan to involved creditors. Under the hypothesis of high consent over the restructuring plan, legalization is not necessary, so restructuring agreement may follow the provisions of private law, since the threat of legal challenge is remote.
Whether the intensity of distress is high, and the support of stakeholders is low, the situation is quite severe, since the firm cannot find rapid solutions through an emergency plan, while it remains exposed to enforcement action: the unique way to avoid further losses of value is the filing for composition with creditors. In case of good level of support by the involved stakeholders, despite the incidence of the requested sacrifices, the reorganization is legalized through the approved restructuring agreement, because the judicial formal control ensures the stability of actions to be undertaken.
The model is resumed in Table 2.2.

	Low commitment	High commitment
Low intensity of the crisis	Certified plan or approved restructuring agreement	Private agreement (no need of legalization instruments)
High intensity of the crisis	Composition with creditors	Approved restructuring agreement

Table 2.2 – Selection of the legal instrument for restructuring plans
Source: Giacosa and Mazzoleni (2012), page 303

2.11. CHOICE BETWEEN JUDICIAL AND NON-JUDICIAL PROCEDURES

From a general point of view, it is possible to state that the institutional framework provides many ways for the resolution of a corporate crisis. The decision between a private settlement or a public procedure is not straightforward, since it depends from the intensity of the distress, the business perspectives and dynamics of relationships among corporate stakeholders.
According to Gilson (2012), firms are more likely to arrange a private restructuring whether it's the value of the business is based on intangible assets and human resources, and the acquisition of revenues from clients depends on trust and the assurance of business continuity, such as consultancy firms and, in general, businesses supplying services characterized by continuity over a definite (or indefinite) time window. In these situations, access to workout ensures the confidentiality about the situation of crisis, since the eventual leak of information leads to the sudden deterioration of corporate image and trust, causing the immediate drop in revenues from the core activities. With respect to the liability side, the presence of a simple financial structure and the prevalence of banking debts favours the unanimous consent on the restructuring plan under private negotiation, thus reducing the legal and procedural costs.

Finally, also the identity of the owner affects the choice: "distressed private equity-backed companies are more likely to restructure their debt out of court, do so in less time, and are more likely to survive than comparable public companies". (Gilson 2012*,* page 30)
By contrary, in businesses where leasing contracts contribute to the financial burden, such as airline companies, it is reasonable to file for a judicial procedure to trigger the renegotiation of the agreements. For the same reason, judicial procedures best fit for the definitive settlement of liabilities representing a threat for the future survival of the firms: we refer to claims derived from tort responsibility, environmental litigations (for example damages related to asbestos), pension agreements and criminal fines. Moreover, a business is more likely to file for a judicial composition whether its financial structure is articulated in many priority levels, it includes publicly traded bonds, and its workforce is unionized, "because voting rules in bankruptcy do not require as large a majority […] to pass a plan, and the judge can resolve disputes [through] cram down powers" *(Ibidem).*
Finally, provision on priority financing within in-court restructuring is valuable for the distressed firm possessing valuable real assets and needing immediate oxygen for the business continuity in the form of bridge loans.

CHAPTER 3 – VALUE CREATION THROUGH FINANCIAL STRUCTURE AND ACTIVE INVESTORS

As widely known, businesses continuously invest financial resources to sustain their core activities and to ensure cash inflows as return for investments previously taken. Situations of imbalance between cash inflows and outflows, which are normal during phases of start-up and growth of businesses, shall be sorted out through the collection of financing resources from external stakeholders mainly in the form of equity or in the form of debt. This chapter is aimed at explaining the impact of the choice about debt or equity financing on the corporate structure and on value creation. Then it is briefly presented the role of some financial operators, private equity investors and distressed investors, specialized in the achievement of rapid increasing in value through the modification of the structure of liabilities in the target firm.

3.1. EQUITY AND DEBT

The definition of equity refers to all the contributions in cash or in kind that external investors permanently devote to a business. Legal provisions state that a firm does not have an *ex-ante* defined contractual obligation to return or to reward the sum received in the form of equity, in fact in case of insolvency the contribution is totally and definitively lost by the investors. As compensation for their contribution, equity investors collectively receive a sort of property right on the business, having the power to appoint and remove directors, who are entitled to take all strategic and operating decision in the company's name, under the mandate to maximize the creation of value for equity investors. Equity investors have also the right to approve extraordinary operations, such as mergers, spin-offs, voluntary liquidations, or radical changes in operating activities. From the financial side, equity investors must approve the yearly financial statements, and, in case of positive economic results, they may ask the firm to pay them the surplus of financial resources generated by operating activities in the form of dividends or share repurchases.

The other main source of financings, debt, refers to financial resources obtained through lending agreements, where the lender provides the firm a certain amount of financial resources (the principal) which shall be returned and explicitly rewarded in conformance to a predefined reimbursement schedule, which is negotiated between lender and borrower according to financial needs and cash flow structure of the business. Because of the variety of financial needs, lending agreements may present very different contractual clauses and debt may be classified according to various dimensions. Some of the most relevant categories of debt refer to the following features:

- Expiration of the lending agreement (short-term or long-term debt);

- Presence of guarantees (secured or unsecured debt);
- Priority level negotiated (senior or junior debt);
- Variability of interest rates (fixed or floating rate debt);
- Presence of options for anticipated reimbursement by the borrower;
- Presence of options for conversion into equity instruments upon discretion of the lender;
- Incorporation of creditors' rights into securities (bond or non-bond debt).

3.2. INTERACTION BETWEEN FINANCIAL STRUCTURE AND VALUE

Under normal market conditions, the mix of equity and debt in the financial structure influences Enterprise Value of a business: considering the synthetical formula for valuation already presented in Chapter 1, the financial structure of a business affects the *cost of capital.* In this context, modifications in financial structure of a firm such as substitution of shareholders' equity with debt financings generates modifications in Enterprise Value, so recapitalizations are eligible to be used as instruments for value creation. The traditional view on debt financings states that debt creates value via increasing of both *Return On Equity*, the ratio between economic result and shareholders' equity, and *Earnings Per Shares,* the economic result divided by number of outstanding shares. But positive effects on EPS and ROE are only part of the effects produced by a change in the financial structure: on the other side the riskiness of cash flow increases, and the cumulated effects is neutral for the Enterprise Value.
Modigliani & Miller, in their famous paper elaborated in 1958, developed a theoretical framework known as First Proposition of Modigliani & Miller, which states that, under ideal conditions, choices about the financial structure of a business are neutral on Enterprise Value. The proposition states that in absence of market frictions, the financial structure is neutral: "the market value of any firm is independent of its capital structure and is given by capitalizing its expected return at a rate appropriate to its class". (Modigliani & Miller 1958, page 268) According to them, the value of a business is contained only in the assets side of the balance sheet, being originated only by present value of future cash flows arising from outstanding investments discounted for a factor which reflects the riskiness of the cash flows. With the help of a famous metaphor, it can be stated that financial structure does not increase the size of the pie, which represents the value of the business, but it only rules the formation of the slices of the pie, so the division of value among investors in the firm's capital.
The neutrality of the financial structure would hold in a perfect capital market, which is characterized by the following assumptions:

- "Investors and firms may exchange the same set of securities at a market price equal to the present value of their future cash flows;

- There are neither taxes, nor transaction and issuing costs connected with trading of securities;
- Decisions on capital structure do not affect the cash flows generated by the firm's investments and they do not provide new information about cash flows". (Berk & DeMarzo 2011, page 482)

Under the hypothesis of perfect capital markets, to obtain economic value of a business, future cash flows originated by operating activities shall be discounted at the unlevered cost of capital (K_A), a discount rate which measures the riskiness of the cash flows and it represents the return required by investors to withhold the overall set of corporate. As suggested by Berk & DeMarzo (2011), in absence of market frictions, the unlevered cost of capital is the average of the cost of equity (K_E) and the cost of debt (K_D), weighted for the respective shares of financial debt (D) and equity (E), both computed at market values) over the Enterprise Value (V), according to the following equation:

$$K_A = \frac{D}{V} K_D + \frac{E}{V} K_E$$

Then, the Second Proposition of Modigliani and Miller suggests the relationship between leverage and cost of equity: the expected return for equity "is equal to the appropriate capitalization rate for a pure equity stream in the class, plus a premium related to financial risk" (Modigliani & Miller 1958, page 771); which is represented by this formula:

$$K_E = K_A + \frac{D}{E} (K_A - K_D)$$

It follows that two hypothetical firms with the same assets base but different financial structures: one financed only by equity and the second financed with a mix of debt and equity, they present the same overall cost of capital ($K_{AU} = K_{AL}$) but the cost of equity for the unlevered firm will be lower than the cost of equity in the levered firm ($K_{EL} > K_{EU}$). The cost of equity measures the financial risk of a firm: if the incidence of debt in the liabilities side of a firm rises, the risk borne by equity holders increases proportionally, also in absence of risk of default. In fact, the presence of debt influences the volatility of rewards to equity capital: if levered and unlevered firm have the same asset base and cash inflows, the commitments to repay outstanding debts reduce the amount of economic profit and cash flows available to equity investors, therefore equity investors in a levered firm ask higher return with respect to a firm financed only by equity. (Berk & DeMarzo, 2011)

However, the First Proposition of Modigliani and Miller holds only in absence of market frictions and it is considered an ideal principle: in the real world, market distortions produce modifications in value of businesses as an effect of changes in the financial structure.

The most known market distortion, which shall be expressly considered in corporate valuation, is the asymmetrical fiscal treatment of remuneration paid to debtholders and equity-holders: while payments of interests on debt is deductible from taxes as a corporate cost, payments of dividends is fiscally neutral from the point of view of the taxation of corporate income. It follows that the presence of financial debt in the liabilities side of a balance sheet produces a fiscal shield which avoids the taxation of part of the corporate profits, thus increasing value created for equity-holders. From valuation point of view, tax savings originated by the deduction of interest expenses shall be estimated and their present value shall be added to present value of cash flows arising from operations to obtain the Enterprise Value. The estimation of the tax savings originated by deduction of financial expenses relies on the assumption that the amount of corporate taxable income is higher than deductible financial expenses, otherwise part of the fiscal shield is inevitably lost. It follows that the obtainment of these tax savings is risky, since it depends on the volatility in cash flows generated from business operations. Therefore, in accordance to Koller *et al.* (2015), to compute the present value of fiscal shield originated by debt, it is necessary to assume that the riskiness of tax savings is equal to the volatility of cash flows arising from operating assets, then to discount the forecasted tax savings at a rate equal to the cost of capital K_A. Assuming also that the debt/equity ratio, computed on market values, is fixed by the firm's directors and it is kept constant to a target level, it is possible to obtain the following formula for the overall cost of in presence of fiscal shield on debt, widely known as *Weighted Average Cost of Capital,* where τ states for the marginal tax rate on corporate taxable income.

$$K_{WACC} = \frac{D}{V} K_D (1 - \tau) + \frac{E}{V} K_E$$

Apart from positive effect of the fiscal shield, the presence of financial debt activates other distortions of capital markets which impact value creation. In Chapter 2, legal and business effects of default and insolvency were presented. In a perfect capital market, the situation of insolvency would simply produce the transfer of corporate assets in the hands of debtholders, as predicted by Merton's model on equity and debt like options, without further losses on Enterprise Value. Unfortunately, direct and indirect costs of insolvency constitute a market imperfection which produces changes in value depending on the financial structure. In fact, a highly leveraged firm shows a certain probability of becoming insolvent and sustaining the related cost of distress, and this probability is higher than a comparable firm financed only through equity capital. Therefore, to compute Enterprise Value of the leveraged business, costs of default shall be estimated and weighted for probability of manifestation, then the expected value shall be deducted from present value of future cash flows originated by corporate assets.

Another category of market imperfections refers to the modifications produced by financial debt on the relationships between management and shareholders. In presence of asymmetrical information and delegation of decisional power by the ownership to management team, the effort of managers is negatively affected by moral hazard. Without an adequate monitoring of the managerial performance and incentive-based compensation, directors and management may put in place initiatives which transfer benefits and value from financial investors to them. For example, they may undertake investment projects characterized by a low or negative Net Present Value or Internal Rate of Return, they may put a low effort on their working activity, or they may set an excessive level of personal benefits and compensations at the expense of the firm. A common type of dangerous choice made by management is the undertaking of investments focused on the enlargement of the business dimensions until a level where economies of scales are not maximized, with only compliance to their personal ambitions, rather than paying attention on the obtainment of a fair Return on Invested Capital. (Berk & DeMarzo 2011)

According to Jensen (1986), the availability of relevant amount of liquidity in the corporate treasury puts an incentive to the adoption of opportunistic behaviour by managers which leads to inefficiencies and reduces the value creation. By contrary, the presence of obligations to repay the financial debt drives away part of the liquidity withheld by the firm, thus increasing the incentive to increase the effort in the managerial activity and to take care about value for shareholders, by avoiding extra benefit and by carefully value the future investment plans. Therefore, in presence of debt, management team shall seek for reliable positive cash flows from business operations which allow the firm to correctly satisfy the obligations of repayment of principal and interest, in order to avoid events of default.

Finally, the presence of debt, especially short and medium-term debt, acts as an instrument of monitoring of the managerial performance because "debt allows investors to discipline management and provides information useful for this purpose [since] they gather information from the firm's ability to make payments and from a costly investigation in the event of default". (Harris & Raviv 1990, pages 322-323) In this context main lenders play the role of external supervisors of the managerial policies, since they will enter in a new debt financing or renew existing loans after a careful valuation of the current investments and the future perspectives of the business.

On the other hand, the presence of a too high level of debt, which is not suitable to be repaid through the expected level of future cash flows, does not incentivizes an efficient managerial activity and the high quality of investment. In fact, when the unsustainability of the debt burden is ascertained, the situation of *debt overhang* attracts risky initiatives characterized by unbalanced profile of return and low or negative expected present value, since only very positive payoff with low probability of manifestation would create value for the shareholders, while the losses would damage only lenders. Also, the asymmetrical splitting of payoffs, produces the consequence that investment projects with a fair and positive Net Present Value are likely to be rejected by the management since the value created by these projects will be devoted only to debtholders rather than to shareholders.

3.3. CHOICE OF THE OPTIMAL FINANCIAL STRUCTURE

At this point it is necessary to summarize modifications of Enterprise Value induced by the interaction of financial debt and environmental market imperfections. To obtain the Enterprise Value of a levered business, it is necessary to start from the unlevered value of assets, which includes the expected present value of future cash flows arising from both outstanding investment and from future growth opportunities. (Damodaran, 2001)

Then the positive effects of debt shall be added to the unlevered value: first present value of fiscal shield on financial expenses, then expected benefits from more efficient management due to the commitments on debt reimbursement. By contrary, asset value shall be reduced by the expected direct and indirect costs of insolvency and by negative effects on the quality of investments caused by an eventual situation of debt overhang. (Berk & DeMarzo, 2011)

To make an appropriate choice of a firm’s debt level, management should first pay attention on the optimization of the fiscal shield: in fact, the amount of financial expenses exceeding the projected EBIT, will not contribute to value creation since it cannot originate deductions on income taxes. Then, debt amount and reimbursement schedule should be sufficiently high to ensure that managers put the appropriate effort on their activities and they avoid unnecessary compensation, but sufficiently low to avoid situation of default and the undertaking of too risky investment. With respect to repayment schedule, it should be based on planned cash flow, forecasted on a conservative scenario: in this way, risk of distress and the expected cost of insolvency, but also transaction cost and refinancing cost are minimized.

Furthermore, a relevant factor to be considered in the setting of financial structure is the need of flexibility to face unexpected situations. The intensity of requested flexibility depends the positioning of the firm and its industry in its own life-cycle, the predominance of fixed or intangible assets in the asset side of the firm, volatility and predictability of the economic result and expected generation of cash. Hence, a firm should be mainly financed with equity when it needs high flexibility due to the presence of multiple uncertainties: for example, if a business is young and innovative, it is facing high investments in research, development and other

intangible assets, it operates in risky and volatile industries, or it presents low revenues but good opportunities for growth. (Damodaran, 2010)
On the opposite side, mature firms belonging to non-cyclical and highly-regulated businesses or characterized by relevant amount of fixed assets and constant generation of cash, present low risk of distress, low need of flexibility and lower volatility of cash flows; therefore, they are eligible to obtain positive effects on value from financial debt through the fiscal shield on interest expenses and through reduction of moral hazard and inefficient choices of directors and management.
With respect to the obtainment of financings through issuance of new equity, it must be considered that equity capital does not imply obligations of reimbursement, so the operation strengthens the financial structure and reduce the risk of insolvency. Unfortunately, increase in share capital is affected by asymmetrical availability of information about future perspectives of the firm between management and potential investors, therefore it is not usually considered for mature firms: adverse selection leads to the scepticism of potential investors who ask a reduction of the equity price demanded by the firm. That is why publicly traded firms announcing an increase in share capital experience a reduction in share price and market capitalization, producing a physiological reduction of investment value and the dilution of shareholders' control rights. (Berk & DeMarzo, 2011)
Also, it is inevitable that equity subscriptions by external investors cause the entry of new shareholders and the need to share decisional powers by setting a new governance structure. The alternative is that incumbent shareholders decide to invest its personal wealth in the firm to keep its controlling position unchanged, but it depends on considerations about personal wealth of investors and their propensity toward risk.
For these reasons, management and shareholders of mature and non-distressed firm does not like to finance the new investments through increases in equity capital, so they first exploit accumulated earnings, then new financial debt as sources of financings. According to the pecking order hypothesis by Myers (1984), the raising of financings through increasing in equity capital is considered by management as a last resort option; by contrary, they devote their effort to remunerate equity investors through payment of dividends and share repurchases. However, the preference order should not be strictly considered in its hierarchy, since in some cases the market conditions and the high level of debt, although not yet unsustainable, determine the managerial decision to obtain new financings via fresh equity capital.

3.4. COST OF EQUITY AND COST OF DEBT

From the perspective of external investors, value of financial instruments is computed from future cash flows which are expected to be received, properly discounted according to time value of money and their riskiness. To set the appropriate discount rate, financial markets do not consider the incidence of specific risks which are likely to affect only the firm issuing the instruments, such as risks connected to managerial errors, turnover of key human resources, weak commercial strategy, or scandals affecting the corporate image. The reason is that investors have the possibility, through the access to global financial markets, to hold a large portfolio of securities whose specific risk are not correlated: investments in such diversified portfolios reduce the volatility of payoff to investors and they are they offer protection to specifics risks carried on by securities.

Therefore, discount rates shall consider risks affecting the overall economy which are not diversifiable trough the holding of a wide investment portfolio: when a downturn in the economy occurs, the value of investments falls because of higher perceived volatility and pressure for selling the securities and liquidation of the positions. This type of risk is the market risk of an investment, and it is measured through a correlation factor (the beta) between return of investment under analysis and return of a portfolio of assets taken as reference.

The Capital Assets Pricing Model, developed by L. Linter and W. F. Sharpe, is the most widely used model for the determination of the cost of capital and it is exemplified by the following equation:

$$r_i = r_f + \beta_i\left(E[r_{mkt}] - r_f\right)$$

CAPM states that riskiness of an investment, and by symmetry rate of return required by investors, is measured by the sum of risk-free rate and an appropriate risk premium adjusted for the sensitivity of the investment to the market. The risk-free rate component *(r_f)* measures the time value of money and it is taken from market yield of securities without risk of default, such as government bonds with AAA rating. The risk premium defined by CAPM is the expected rate of return *($E[r_{mkt}]$)* of a very diversified portfolio of securities: the most used proxies for this portfolio are represented by worldwide indexes of equity securities such as S&P 500 or MSCI World Index. The risk premium shall be multiplied by the beta of the security *(β_i),* which measures the sensitivity of the return of the security with respect to the return of the market portfolio. This model is widely used in the determination of the cost of capital because of its solid theoretical background, its immediate practical application and the focus on a single and measurable risk factor. (Koller *et al.,* 2015)

Damodaran (2001) states that risk premium of securities is also influenced by the nationality of the issuer: countries presenting emerging economies or political instability are riskier than advanced and growing countries such as Germany and United States. To properly include the country risk in determination of the cost of capital, he suggests considering the country rating and to multiply the related default spread by the ratio between volatility of local equity and local government bonds. The computation gives the Country Risk Premium, which shall be added to market risk premium previously computed.

With this specification, formula for computation of cost of capital becomes

$$r_i = r_f + \beta_i\left(r_{CRP} + E[r_{mkt}] - r_f\right)$$

where $$r_{CRP} = Default\ Spread \times \frac{\sigma_{Equity}}{\sigma_{Government\ Bond}}$$

When discount factors have been determined, market value of equity and debt claims issued by a specific business may be computed by first estimating payoffs which are expected to be originated by the instrument and then discounting them at the appropriate risk profile. Since the accounting equivalence between assets and the sum of equity and liabilities shall hold not only for nominal values, but also for market values, an accurate estimation of the Enterprise Value of a business must be equal of the sum of market values of its outstanding shares and financial liabilities.

From these considerations, it follows that payoffs to be used inputs for the valuation of operating assets, debt and equity instruments are:

- Expected value of future cash flows generated by the business, for operating assets value;
- Expected value of repayment of principal and interests, for debt claims;
- Expected value of dividends and accumulated earnings, for equity claims.

Also, applicable discount rates change among instruments because of diversity in the risk profile of debt and equity claims, due to the priority of debt repayments and the symmetrical residuality of payoffs to equity holders. It follows that the applicable discount rates are respectively:

- Cost of capital (K_A), measuring the operating risk of the overall business;
- Cost of debt (K_D), measuring the default risk on bonds and other financial liabilities;
- Cost of equity (K_E), measuring the financial risk connected to equity holdings.

Cost of capital, cost of equity and cost of debt are measured according to Capital Assets Pricing Model, by adding to the rate of return of risk-free security prevailing on the financial markets the return of the market portfolio, eventually corrected for country risk, adjusted for the respective correlation factor β. The methodology requires the choice of appropriate reference financial instruments and carefully measure its rate of return to obtain consistent and useful proxies of risk-free rate and the return of the market portfolio.

Like the costs of equity and debt, also the betas for debt and equity within a business are tied by the Second Proposition by Modigliani and Miller, according to the following equation, which includes also the effect of tax shield of interest expenses:

$$\beta_U = \frac{D}{V}(1-\tau)\beta_D + \frac{E}{V}\beta_E$$

From a practical point of view, equity beta of a firm is directly measurable only for listed companies and it is determined from the linear regression between the historical return of the share and market portfolio. The reliability of equity betas of a company determined on market data is based on the implicit assumption that the capital market is efficient, and it correctly prices the security under analysis, so it is important to verify the reliability of the observed beta through the following procedure, suggested by Koller *et al.* (2015), which shall inevitably be used for valuation of unlisted firms because of lack of data.

The indirect determination of the equity beta requires two input factors: the unlevered beta, computed at industry level, and the leverage ratio (D/E) of the firm under analysis, computed from their market values.

To obtain industry beta it is necessary to identify a sample of listed firms comparable to the business to be valued in terms of expected future cash flows and volatility: the exposure to the same market forces and competition determines the reasonability of the implicit assumption that businesses belonging to the same industrial sector are more likely to present comparable riskiness and cash flows profile. (Damodaran, 2001)

The following step is the measurement of the beta equity for each firm of the sample through a linear regression between the historical return of the comparable and the return of the reference market portfolio previously chosen. The regression should include at least 60 points on monthly return, to ensure the statistical relevance of the result (Koller *et al.,* 2015, page 298). At this point, it is needed to separate the riskiness of equity depending on the financial structure from the riskiness depending on the underlying operations to obtain the unlevered beta. So, for each firm, it is necessary to take the weighted average of observed beta equity and beta of debt. With respect to the latter value, Koller *et al.* (2015, page 301) suggest taking an approximated value of 0.3 which is valid for non-distressed businesses. Weight factors shall be the incidence of

market values of equity and net debt in the financial structure, according to the formula previously seen.
After the obtainment of a set of unlevered betas related to firms included into the sample, the median value is reasonably the unlevered beta for the industry. The median value is preferred by Koller *et al.* with respect to the simple average because the effect of outliers is excluded. Finally, to determine the equity beta of the target firm the industry unlevered beta is adjusted to re-include the financial risk originated by the presence of debt on the target firm, according to the following formula:

$$\beta_E = \beta_A + \frac{D}{E}\,(\beta_A - \beta_D)$$

Unlevering and relevering of beta factor is needed in determination of the opportunity cost for equity investments, since it included the overall market risk borne by equity investors, which is the sum of operating risk and financial risk. Operating risk, measured by unlevered beta, depends on correlation between the volatility of cash flow generated by the business and volatility of the market portfolio. Therefore, industries with low unlevered beta show low business riskiness, since their revenues and EBITDA are not likely to be eroded by economic downturns, while the financial performance of industries with high unlevered betas is heavily affected by situations of crisis.
On the other hand, financial risk measures risk borne by equity investors of a leveraged firm with respect to an investment in shares of an identical firm financed only though equity capital. In fact, the presence of financial debt constitutes an element of rigidity which influences the expected of compensation to equity holders: because of the priority repayment of principal and interest, eventual limited reductions in cash flows and EBITDA from operating activities, may lead to wide reductions in the distribution of dividend and cause relevant losses in shareholders' equity. Therefore, notwithstanding the risk of default on debt repayments, financial risk is determined by the simple presence of financial debt and it is directly correlated to leverage ratio. (Berk & DeMarzo 2011)
Moving to determination of financial liabilities value, it is influenced by risk of default, which is the risk that principal and interest are not timely honoured by the borrower because of a situation of insolvency. Since the intensity of trading of listed bonds on financial market is very limited, it is not possible to measure the beta of debt through linear regression models. Therefore, it is necessary to determine a credit rating, which is an assessment of the solidness of the firm issuing the debt and its expected capability to honour its financial commitments. While, for listed bonds, the credit rating is assigned by specialized agencies who evaluate the issuer through proprietary models, for other forms of debt is necessary to observe relevant

financial ratios such as leverage, interest coverage and EBITDA/debt ratio to determine a synthetic credit rating. Then, according to Koller *et al.* (2015, page 305), cost of debt for investment grade firms is determined from "the average yield to maturity on a portfolio of long term bonds with the same credit rating". By contrary, for speculative debt instruments (which are assigned a credit rating below than BBB) it is more accurate to perform an analytical valuation of expected cash flows to debtholders. The valuation is performed by modelling some positive and adverse scenarios, then by assigning their probability and finally by estimating the financial resources available to debt repayment in each scenario. In these situations, the economic value of debt differs from nominal value of contractual repayments and it is obtained by discounting the expected payoff at the cost of debt for investment grade securities (K_D); the actual return for the investor (on a mark to market basis), or Yield-to-Maturity is the discount rate r^* which properly discounts promised debt repayments to make them equal to computed economic value, according to the following equality:

$$\frac{E(Cash\ Flows)}{1+K_D} = \frac{Nominal\ Value}{1+r^*}$$

Since debt is usually subject to preliminary valuation of the lender and the issuance of guarantees which makes the insolvency risk very modest for mature firms, the observed cost of debt is quite low. Cost of debt rises when its weight in the corporate financial structure is predominant with respect to equity value and disequilibria in the sources of financing produces a relevant risk of insolvency. In this situation the risk profile borne by debt holders becomes similar to risk faced by shareholders of a mature and non-distressed business, according to Merton's option theory of financial structure.

In conclusion, cost of capital is the weighted average of cost of equity and cost of debt, and it represents the risk borne by an investor who owns both debt and equity instruments of a business in proportionate shares. In this way, the investor is exposed to a risk equal to the volatility of cash flows directly originated by operating activity. The computation of cost of capital is easy in the case the firm is committed to keep constant leverage ratio at a target level and the riskiness of the fiscal shield of interest expenses is the equal to operating cash flow riskiness: in this case the cost of capital is the Weighted Average Cost of Capital.

When leverage ratio is not constant, financial practitioners suggest the computation of a business' assets value according to the Adjusted Present Value method. This methodology consists in the estimation of value of the operating cash flows, under the hypothesis of absence of financial debt; then present value of fiscal shield on interest expenses is separately estimated and its present value is added to present value of business operations.

3.5. ACTIVE INVESTORS

In developed countries, financial markets constitute the infrastructure where consumers and institutions, holding surplus financial resources arising from their personal savings, are put in contact with subjects who have an immediate need of liquidity; through this market they may satisfy their reciprocal needs with mutual benefit and higher efficiency for the economic system. Under the hypotheses of efficiency of financial markets and the absence of arbitrage opportunity, all financial instruments are exchanged at a fair price, so sellers and acquirers cannot create economic value through the only trading of securities. In this sense, "trading is a zero-sum game [since] the total gains of winners are exactly equal to the total losses of the losers". (Harris 2003, page 176) Moving from theory to real world, it is difficult that market price of securities fully reflects the best estimate of uncertain fundamental value, mainly because prices are affected by the behaviour of traders who possess different level of information on fundamental value. In this framework, trading is not a zero-sum game anymore, since speculative investors have the possibility to create value by properly analysing the available information to infer the mispricing of financial products, then trying to trade the mispriced security and to profit from the correction operated by markets.

Moving a step forward, some players in the financial markets, that we call active investors, are involved in augmenting the efficiency of the overall economic system. In fact, financial markets favour the transfer of property rights of businesses to their respective "best owners", who are the controlling subjects possessing the capabilities and competencies to maximize the Enterprise Value, and, in this way, markets increase the efficiency of the overall economic system by ensuring best exploitation of assets and resources. The transferability of undervalued businesses allowed by financial markets has also a positive role in corporate governance, since the threat of substitution reduces the risk of inept management by incentivizing a maximum effort toward efficient and sustainable value creation. (DePamphilis, 2015)

For example, it may happen that some operators recognize in advance that directors of a listed company are carrying on inefficient strategies, which are not capable to maximize value created by available resources. Therefore, its market value of equity declines to reflect the lower potential for future value creation; in this way the firm becomes cheaper and an external investor may be interested in buying a controlling stake of it through a tender offer. The investor buys the equity stake at its current market value, which is depressed by the inefficient management, then he elaborates and implements a more efficient business strategy aimed at increasing the overall Enterprise Value. If the strategy is successful, the new owner of the business obtains a remuneration for his intervention equal to the increase in market value of the financial instruments he owns caused by the better strategy. (Favotto *et al,* 2012)

The investor who implements this active strategy for creating value may be an industrial investor or a financial investor. The industrial investor is a firm involved in ordinary industrial activity which is interested into acquisitions of other businesses as part of its corporate strategy. Beside the undervaluation of the business to be acquired, the investor puts its attention on the creation of value through the synergies from the integration of the target firm into the acquirer. Although the intensity of their activism on the financial markets is led by the planned strategy for growth and obtainment of valuable resources, industrial investors occasionally perform acquisitions and they are focused on business related with their activities, according to a strategy of horizontal expansion, vertical expansion or diversification. (DePamphilis, 2015)
On the other hand, financial active investors are constituted by institutions who act as intermediaries between holders of excess financial resources and businesses; their activity is to collect savings and to invest the amount collected into inefficient firms, then to boost their value creation through the substitution of top management and the change of strategy. Financial active investors may be classified as mutual investment funds, pension funds, hedge funds and private equity firms. While mutual funds and pension funds buy small equity stakes and they address their activity in the improvement of corporate governance by challenging management on "issues as antitakeover defences, CEO severance benefits, and employee stock option accounting"; hedge funds and private equity firms are focused in changing "a firm's strategic, operational, or financial strategies, often generating attracting financial returns for shareholders". (DePamphilis 2015, page 33)

3.6. PRIVATE EQUITY

Investment funds managed by private equity firms are characterized by high average return which matches the riskiness of their investment strategy: for this reason, money they collect and invest derives from institutional investors and high net worth individuals. Private equity firms are devoted to maximization of net value of the fund in the interest of their investors by undertaking the right choices of investment, improvement of value and dismissals. To properly collect money from investors and manage the investments in operating businesses, the private equity firm constitutes one or more investments funds, which legally constitute sets of assets separated from each other and from the private equity firm. Financial resources owned by the investment funds, constituting their equity capital, are contributed by investors, who are given as counterpart the proper number of quotas in the fund. Investment funds sponsored and managed by private equity firms are usually closed-end funds: the capital contributed by investors is tied for a defined period, it follows that investors cannot ask the anticipate repayment of invested capital before the agreed expiration date of the fund.

From the point of view of managers of the private equity firm, the expiration of the fund represents their commitment to liquidate it within a defined date, by selling the controlling stakes of the target firms and then refunding the investors. The result is that improvements of Enterprise Value in the target investments deriving from higher efficiency in financial and operational policies are expected to be achieved in a medium time horizon and then monetized through a strategy for their dismissal carefully defined from the beginning. On this point, a paper by Achleinter *et al.* (2012) explains that private equity firms have three main channels to exit from an investment while "attempting to realize the value created over the holding period: […] public, private and financial […] The public exit channel refers to the initial listing on a stock exchange, the IPO, and the subsequent sell down of the stakes. […] The private exit channel refers to the sale to a strategic acquirer, and to buybacks and management buyouts or buyins. [Finally,] the financial exit is the sale of a portfolio company to another PE firm" (pages 102-103). The authors exclude bankruptcy as an exit strategy, since it is a necessary outcome in case the implemented strategy to improve the Enterprise Value was not suitable for the business. From their empirical analysis, it results that the 55 % of firms acquired by the observed private equity funds were sold to a strategic investor, the 31 % of the sampled firms were sold to financial investors and the 15 % was listed in the stock exchanges.

Private equity firms create value for their investors through the provision of financial engineering and operational expertise to their target firms: operational and financial engineering are strictly intertwined since the new financial structure "drives the need to the operating performance to meet debt service requirements; in turn the anticipated improvement in operating performance enables the firm to assume greater leverage". (DePamphilis 2015, page 480) Financial engineering is defined as "the creation of a viable capital structure that magnifies financial return to equity investors" *(Ibidem)*, and it exploits the previously presented imperfections of financial markets which allow the choices about financing a business to affect its enterprise value.

From the historical point of view, private equity firms took origins in the United States in the 1970s and their rapid growth in economic importance was strictly related to the development of the market of junk bonds, financial instruments with high risk of default and high nominal yield, devoted to the collection among institutional investors of debt to finance risky operations. The most famous sponsor of private equity transaction was the investment bank *Kohlberg Kravis Robert* (KKR) founded in 1976, which, through its specialized funds, undertook the big acquisition of RJR Nabisco, a group operating in the tobacco industry. (Potito 2009) The most common private equity strategy was focused in public-to-private transactions, which consisted

in the acquisition of listed companies which operated in mature businesses and did not present concentrated and stable ownership, through tender offers aimed at delisting the target firm.
The U. S. economic crisis in the early 1990s determined the crisis of private equity since many firms were obliged to declare bankruptcy: reduction of their operating margins caused the unsustainability of the debt burden. The problem was emphasized by the market euphory in the years between 1985 and 1990, which led to the overpayment of many target firms in the context of the leveraged transaction, and the subsequent assumption of unsustainable financial burdens: the typical example is the above-mentioned RJR Nabisco, which was restructured and sold in 1991 because the cash flow generated by operation was lower than the expectations. The private equity market experienced a phase of decline and it was affected by bad reputation since in that period investors bore spectacular losses.
Nowadays, private equity firms operate in advanced countries with attention on the sustainability of the transactions and they are especially focused on the acquisition of non-listed companies and non-core divisions to be dismissed by bigger firms. The new positive wave of private equity had been permitted by the availability of below-investment grade bonds and new products of financial engineering, which, until financial crisis of 2008, were considered by U. S. financial institutions a source of financing more relevant than traditional banking loans. (Whitman and Diz, 2009)
Finally, it is possible to say that private equity investments are characterized by high level of cyclicality, since capital committed by investors rises in the positive phase of the economy and it rapidly falls in downturns: in fact, private equity experienced another period of euphory in 2006-2007, before the subprime loans crisis, followed by a sharp decline in 2008. (Kaplan & Stromberg, 2009)

3.7. LEVERAGED BUY-OUT

As described by Kaplan & Stromberg (2009), the main instrument of financial engineering, employed by private equity investors to modify the financial structure while boosting the creation of Enterprise Value, is Leveraged Buy-Out. The term Leveraged Buy-Out defines a set of techniques consisting in the acquisition of a firm through financial resources obtained from loans and bonds provided by financial institutions; then, after the completion of the acquisition, the obligation to repay the debt is assumed by the acquired firm.
Through Leveraged Buy-Out, private equity investors obtain the control of target firms with a limited investment of equity capital: in this way the private equity firm expects to maximize the rate of return for investors. After the liquidation of the investment fund, investors firm expect to obtain a positive return which benefits from both the expected Net Present Value of the fiscal

shield on financial expenses and from the additional value created by the higher operational efficiency.

In practical terms, Leverage Buy-Out acquisitions are characterized by a two-steps transaction: in the first phase the investor acquires the majority of the target's share capital through a debt financing, then in the second step the target firm assumes the obligation to repay the debt. The aim of the latter transaction is to ensure the direct satisfaction of debt obligations through the cash flows of the target firm itself. (Potito, 2009) In fact, in this way, the investor is allowed "to pledge the assets and future cash flows of the target firm as collateral for his acquisition debt". (Müller and Panunzi 2004, page 1221)

From the target firms' point of view, financial resources obtained through the loan negotiated by investors are completely devoted to the seller of the business, without affecting the target's balance sheet in the first step of the transaction. After the second step the situation changes: the target firm assumes all the obligations connected to the transaction. The consequence is that a relevant part of operating cash flows arising from the business conduct are driven out from the firm and devoted to the satisfaction of lenders to comply with the interests of investors. By consequence, debt reimbursement negatively impacts the cash flow statement of the target firm, since the original debt was never entered in the corporate treasury, neither it was used to undertake investments with a positive effect on the future cash flows, except for the fiscal shield on interest expenses. With respect to profit and loss statement, it is negatively affected by the interests, but this effect is partly compensated by the reduction of income taxes due to the deduction of financial expenses. Since the debt burden puts pressure in the cash management, the firm's directors are forced to remove all the inefficiencies in corporate governance and operations to satisfy all the outstanding obligations and to achieve a positive net result in the profit and loss statement. For example, the management put its effort in the reduction of the costs and the volume of working capital, in the dismissal of non-core assets and business units and the maximization of return from new investments. (Potito, 2009)

To be eligible as target for acquisitions by private equity investors, and especially leveraged acquisitions, industrial firms shall present, from the economic and financial side, high positive levels of EBITDA and strong generation of cash flows to permit the adequate remuneration of their investors in both debt and equity instruments. Their financial structure shall be characterized by very low leverage ratio and unexploited debt capacity, to properly take the benefits on value creation arising from the financial debt; also, the firm shall constantly generate a return rate higher than its cost of debt. The interest in LBOs increases if the target firm owns a wide base of real assets, especially real estate assets, which are eligible to be sold in liquid markets at a price higher than its accounting value without negatively affecting the core business activities. (Potito 2009, pages 165-166)

From the strategic side, these firms should operate in mature businesses with low risk and constant generation of revenues, which is not relevantly affected by the physiologic cyclicality of the economy. The firms should also stay in the maturity phase of their lifecycle and present a low need of investments in operating assets; by contrary, firms in a phase of expansion are not eligible because of a bigger share of the cash flows shall be devoted to investments in fixed and working capital to properly satisfy the growing clients base. Finally, at the organizational level, the business should possess a clear and stable functional structure and a managerial team capable and motivated toward the change and the improvements. In fact, to ensure the success of the LBO, the target firm shall rapidly overcome the two main shocks induced by the transaction: the sudden change of the reference shareholders and the presence of a relevant percentage of debt in the liability side of the balance sheet. (Potito 2009, page 169)

Michael Jensen (1989) confirms that the best candidates of LBO transactions are "low-growth, old-line firms [that] don't typically invest in R&D" (page 82), since from his empirical study a very small fraction of a sampled businesses involved into this type of transactions reported Research and Development costs in their financial statements.

With respect to rise of Merger & Acquisitions through Leveraged Buy-Outs, which is typical in periods of economic prosperity, a famous paper by Michael Jensen (2010) states that, first, leveraged transactions have effectively achieved their objective to create value for shareholders "from real increases in productivity rather than from simple wealth transfers to shareholders from other parties such as creditors, labour, government, customers or suppliers" (page 77). He affirms that active investors have originated a new corporate governance structure, characterized by higher efficiency than the traditional conglomerate firm: the strategic decision about buying, holding or selling a business are taken by the investment firms, which are structured as agile partnerships employing some tens of people and they "play a role that is similar in many ways to that of the main banks in the Japanese groups of companies" (page 80). The efficiency of the strategic choices is helped by the practise of relating the decision makers' compensation to the performance of the investment funds they manage, and by the absence of interconnections among the businesses belonging to the same investment firm, which, differently from diversified corporations, make impossible the transfer of cash between two operating firms.

With respect to the high debt burden connected to LBOs, an eventual economic crisis is likely to reduce the operating cash flows and the Enterprise Value, quickly leading the firm to the insolvency. However, the costs of insolvency of highly leveraged firms is estimated to be much

lower if compared to traditionally leveraged firms presenting a Debt/Value ratio close to 20 %. In fact, highly leveraged firms in default have residual Enterprise Value much higher than Liquidation Value, so "there is [high] value that can be preserved by resolving the insolvency problem in a fashion that minimizes the value lost" (page 83). By contrary, traditionally leveraged firms in default present such a low residual value liquidation is the most reasonable solution, with the connected conflicts among investors and misallocation of valuable assets.
As seen in Chapter 2, because of the concentration of debt claims and the relevance of going-concern value in highly leveraged firms, the composition of the crisis though an out-of-court procedure is more favourable than a judicial procedure. In fact, "it is likely to be more costly to trigger the cumbersome court-supervised bankruptcy process that diverts management time and attention away from managing the enterprise" *(Ibidem)*. Through a private settlement of the crisis, the stakeholders avoid the procedural costs of bankruptcy and their connected indirect costs. Also, the conflict of interests between different classes of shareholders, which in normal condition require the intervention of the bankruptcy court, are reduced since in LBO transaction "claimants hold approximately proportional strips of all securities" (page 84).
Definitively, Leveraged Buy-Out transactions are powerful instruments to re-boost the process of value creation for mature and slow growing firms because the high level of debt and the alignment of managerial incentives put pressure on efficiency and to the adoption of best practises in governance and operating activities. With respect to debt instruments financing the transaction, they are riskier than normal debt and exposed to the cyclicality of the economy, so they may be considered as quasi-equity instruments and they fit for speculative investors, but on the other hand they limit the complexity of reorganization in case of insolvency. The market of LBOs is also highly cyclical, with both high volume of completed transactions, and profit obtained by investors in periods of prosperity and, symmetrically, low number of LBO acquisitions and relevant losses during economic downturns.

3.8. LEVERAGED BUY-OUT TECHNIQUE

Although leveraged transactions may be undertaken in several ways, the most common scheme consists in the constitution of a specific corporation which undertakes the acquisition of the target company, then financial debt is transferred from the vehicle to the target through the merger of both companies. After the investors have selected the target of the acquisition, they have obtained all the information required with the consultancy of an investment bank together with legal and accounting professionals, they constitute a limited liability legal entity, the so-called "New Company" as vehicle for the acquisition. The NewCo negotiates the provision of the financial resources necessary to pay the seller in two forms: for the part of the price which is disbursed by the private equity investor, in the form of equity capital contribution, while the part which is covered by debt is received through a bridge loan provided by specialized financial intermediaries. The bridge loan is a short-term loan undertaken to permit the payment of the acquisition price to the seller, and it is bound to be refinanced by definitive long-term loans or bonds after the completion of the acquisition.

Then, the NewCo prepares a formal tender offer to target firm's shareholders, whose definitive acceptance produces the transfer of financial resources to the NewCo, then from the NewCo to the sellers; and symmetrically the ownership of shares whose holders accepted the offer is transferred to the NewCo. Finally, the NewCo is merged by incorporation into the acquired target firm, transferring the financial debt in the head of the operating firm itself. Alternative techniques to produce the assumption of financial liabilities by the target may imply the transfer of financial resources from the target to the NewCo in the form of dividends, royalties or unfair prices for supplying of goods and services. (Potito, 2009 and Müller and Panunzi, 2004)

At this point, the definitive financing agreements are signed between the financial institution sponsoring the transaction and the operating firm. According to Kaplan & Stromberg (2009) and Potito (2009), the overall financial structure is composed by a mix of different debt instruments with different priority levels and different amortization plans reflecting the future cash flows as projected by investors and management. For example, in the Anglo-Saxon environment, financial debt ranges from the 60 % to 90 % of the acquisition price, while the remaining share from 10 % to 40 % of the price are contribution in the equity capital of the NewCo coming from the investors promoting the transaction. With respect to debt financings, its normal composition is characterized by priority senior debt on a percentage from the 50 % to 70 % of financial liabilities and by junior debt or hybrid instruments of debt plus call options on the remaining part.

A relevant part of the financial term sheet disciplines the provision guarantees on the obligation to repay the debt. First, financing institutions negotiate a set of covenants aimed at ensuring the sustainability of financial structure and the efficient conduct of the business, to create the best situation that ensures punctual repayment of principal and interests. In fact, covenants constraint the managerial decisions impacting on economic result and cash flows, since their breach constitutes an event of default which gives the lender the right to ask the immediate repayment of the outstanding debt. The most common covenants are referred to the setting of target economic and financial ratios to be respected by the business, the level of operating and financial investments, the possibility to modify the structure of equity and liabilities through distribution of dividends and undertaking of new loans.

Then, the financial term sheet regulates the issuance of collaterals by the resulting firm to the lenders as guarantees in case of default. Collateral are constituted by pledges and mortgages on real and financial assets owned by the operating firm, in conformance to the applicable law; in some cases, they may be provided also by third parties, such as investors in the private equity funds. It must be remembered that, through the merger of the two firms, the lending institutions enjoys the generic guarantee on the overall set of assets automatically provided by contract law. It follows that within the contest of the LBO, the assumption of financial debt by the target firm increases the collateralization of the loans, thus strengthening the position of lenders. In fact, if the merger between NewCo and target firm, or the other transfer of the financial liabilities did not take place, the financial debt would be guaranteed by the NewCo assets, which would have only consisted in the shares of the target firm and the eventual cash on treasury. From the lender's point of view, the only collateralization of target shares is quite risky: in fact, in the case the target firm is not listed, as usual for private equity, their market value is difficult to be determined since it depends on the availability of information about the issuer, at the same time it is quite difficult to find an acquirer for the pledged share package than for eventual valuable real estates owned by the target firm.

With respect to business law provisions regulating Leveraged Buy-Out transactions, it is important to highlight that Italian Civil Code states at article 2358 that financial assistance is forbidden: it means that corporations shall not offer loans and guarantees to favour the transfer or the subscription of their own shares. When the first leveraged transactions were undertaken in Italy, a minority of business law scholars pointed out that the scheme violates the prohibition of financial assistance on its substantial aspects, since, after the merger between the target and the NewCo, the target firm guarantees the transaction with the assets it owns.

According to Potito (2009), the reform of corporate law in 2004 has overcome these doubts by specifically regulating leveraged transactions through the article 2501-bis of Civil Code. The reform increases the transparency of the leveraged transactions toward stakeholders and investors through the mandatory disclosure of relevant information, with the aim to verify the presence of solid strategic and financial rationale for the acquisition. In fact, the draft term of the merger between the NewCo and the target firm shall disclose these information:

- the financial resources needed to satisfy the outstanding obligations;
- the business rationale of the transaction;
- a business plan explaining the operating goals and the source of financial resources

Furthermore, the following documents shall accompany the draft term of merger: a report by the external auditors of the involved firms and a certification on the reasonableness of the merger from an independent expert. (Potito 2009, page 176)

3.9. LBOs AS SOLUTION OF HOLDOUT PROBLEM IN ACQUISITIONS

From a general point of view, transactions aimed at the transfer of business take place when increase in value creation and higher efficiency for the overall economy are expected. In fact, the acquirer profits from the transaction if the generates a positive difference between the price paid for the acquisition and the value generated by its activity aimed at the removal of inefficiencies or at the achievement of synergies in combining and integrating the acquired business with others. (Koller *et al,* 2015)

A fundamental assumption is that both the seller and the acquirer define the economic value of the business on the ground of the expected present value of future cash flows and agree on its determination. This value defined by parties is the minimum selling price which shall be paid to the seller. In some cases, this hypothesis is not verified since the transaction is affected by asymmetrical information, so the seller, especially for small firms, does not clearly know the perspectives of his business, or he prefers to retire from entrepreneurship rather than obtaining a price reflecting the fair market value.

According to Grossmann and Hart (1980), under the hypothesis that price is not affected by asymmetrical information and both parties agree on the market price of the business and on the value of synergies, the transaction may be affected by the holdout problem. In fact, since the seller reasonably knows that the acquirer undertakes the transaction because he expects to create additional value from the increasing of the efficiency of the business, he will try to obtain part of the acquirer's profit, corresponding to part of the value of synergies, by asking a selling price higher than its current market value. According to game theory, the acquirer will agree on the request if he still expects to obtain a positive surplus for the transaction, it means that extra price asked by the seller shall be lower than the expected improvements of Enterprise Value for the target firm. By contrary, if extra price requested is equal or higher than the expected value of improvement, the acquirer refuses the transaction since he would be damaged by it, and therefore the seller would not realize the value of his business.

In the context of the acquisition of a listed firm through a tender offer the holdout problem becomes severe and, as explained by Müller and Panunzi (2004), Leveraged Buy-Out is a useful technique for ensuring the success of the transaction by neutralizing its effects. In this situation incumbent shareholders receive a proposal to buy at a fixed price by the potential acquirer. Small equity holders have the incentive to refuse the offer, if they hope that a sufficient number of shareholders, allowing the obtainment of a controlling stake, accepts the proposal and sells the shares to the acquirer. In fact, by refusing the proposal, the small shareholder keeps its status and he may enjoy the improvements of equity value due to the activity of the new controlling shareholders. This incentive to refuse leads to holdout situation since nobody will accept the tender offer: the transaction will not take place and the planned improvement of the business will not occur, thus avoiding opportunity to profit for the sellers and the acquirer.

A possible solution, proposed by Grossman and Hart, which ensures the success of the transaction by neutralizing the holdout problem is the declaration of the acquirer who promotes the tender offer to expropriate part of the target's assets by directly acquiring them at a price lower than their fair value or, more generally, to undertake commercial transactions with related parties at conditions not aligned with market prices. According to this plan, minority shareholders who do not accept the tender offer lose the opportunity to profit from the improvement of Enterprise Value originated by the change of control. In fact, positive effect on equity value due to the implementation of a new strategy is compensated by reduction of equity value caused by the conduct of unfair transactions. In fact, the hypothetical transfer of assets is decided and conducted by the majority shareholder who acts both in his personal name and in the name of the firm he controls. In this way the majority shareholder or a company related to him who receives the assets, obtains an economic profit equal to the loss borne by minority shareholders, which should reflect its expected compensation for the acquisition of the target company and the managerial actions taken to boost its Enterprise Value.

Unfortunately, according to legal rules about companies, the transfer of assets among related parties at unfair price is forbidden since the management shall comply with fiduciary duties towards the overall set of shareholders, so management must not undertake operations which damages the shareholders. Therefore, the management and the controlling shareholders who undertake similar operation are highly exposed to legal suits by the minorities, and it is likely that the court challenges the unfair transaction or obliges the controlling subjects to compensate the damage caused to minorities.

Instead, Müller and Panunzi state that the announcement of a Leveraged Buy-Out transaction by the potential acquirer who promotes the tender offer, although it has a similar economic substance from the point of view of the minority shareholders, it represents a possible solution of the holdout problem since it presents a lower legal risk. The similarity between LBO and the transaction with related parties is that through the assumption of financial debt, part of the pre-existing value of equity capital is transferred to the holders of financial debt. Although this transfer of value, reduced the overall equity capital, the management who undertakes a Leveraged Buy-Out transaction is reasonably not guilty of violation of fiduciary duties toward minority shareholders, since also controlling shareholders are negatively affected by the transaction. In this situation, a legal suit for violation of fiduciary duties may be initiated only if there are evidences of fraud: the compliant shall prove that, according to an *ex-ante* examination of the business, the impossibility to satisfy obligations of debt repayment through operating cash flows was easily ascertainable from information available at the time of the transaction.

3.10. DISTRESSED INVESTORS

In a situation of financial distress, notwithstanding if originated by highly leveraged transactions, another type of activist investors may enter the scene and take the control of the reallocation of property rights: the distressed investors. Like private equity firms, distressed investors are financial intermediaries who collect savings from peculiar classes of investors, then they establish one or more investment funds which undertake and actively manage the operating investments.

The target of distress investors is very different from private equity firms: they acquire securities issued by companies that are unlikely to satisfy their obligations or that have recently filed for bankruptcy procedures to restructure their financial exposition. The purchase of debt claims which are defaulted or unlikely to pay is aimed at obtaining a key role in the phase of negotiations for the restructuring of liabilities and the subsequent reallocation of the property rights in the distressed firm. Distressed investors expect to obtain a profit for their investors from the spread between the purchase price of distressed claims and the price obtained from the selling of the business after restructuring or proceeds from its eventual liquidation. They may also arrange bridge loans devoted to their target firms whose continuation of the operating activity is threatened by the lack of liquidity on treasury. (Moyer *et al.*, 2012)

The outcome of distress investing is conditioned on the uncertainty about both the reorganization process and the implementation of a new effective business strategy which permits the definitive overcoming of the crisis. To maximize the value obtained from distress investments, they are characterized by a medium-long time horizon rather than the short term; in this manner the investor works for a comprehensive strategy aimed at the full recovery of value destroyed by the crisis and then he considers the dismissal of the target.

It follows that successful distressed investors are characterized by early identification of the firms which present a situation of potential distress and by clear understanding of the causes of poor performance and insufficient generation of cash. In fact, their analysts try to predict the dynamics of the customers' behaviour and the competition within specific industrial sectors to focus on a subset of firm which are likely to enter in a situation of decline. When a firm presenting actual or potential difficulties in the satisfaction of its outstanding obligations is identified, the investment fund enters in the firm if it considers that the underlying business activity is valuable and if the involved stakeholders give him the possibility to quickly decide and take all the necessary actions for the restructuring and recovery of the business.

Timeliness of the intervention by the distressed investment funds is a critical variable which conditions the financial return obtained by the distressed investor: an early entry of the investor, although it implies higher cash disbursement for the distressed securities, presents higher probability of ending up in a successful restructuring and a profitable exit. By contrary, whether the distressed investor intervenes in a later phase of the business' decline and crisis, the financial instruments are acquired a very low price, but the return to value creation requires high effort and further investment by the fund and it present a more uncertain outcome. (Zotti, 2017)

The entry of distressed investors in a distressed firm is characterized by the acquisition of a relevant share of one or more classes of defaulted debt claims. According to Moyer *et al.* (2012), first the distressed investor undertakes an estimation of the residual Enterprise Value of the distresses business, which is compared with the nominal value of the outstanding liability. Then, it analyses the level of collateralization and priority rights of each financial claim, trying to identify the claims which are not expected to be fully repaid in case of liquidation. In this way, the investor tries to identify the fulcrum security, a subset of financial instruments which present high probability of insolvency on principal and interest, so they are likely to be converted in equity within a restructuring procedure. For listed bonds, the consolidation of the majority stake of the bonds in the hand of the distressed investors, facilitates the negotiations and limits the holdout problem, since it becomes easier to obtain the required quorum for the conversion of debt instruments. Also, the distress investor may acquire financial instruments belonging to different classes: in this way he limits the conflict between different classes of creditors and the subsequent risk that inefficient choices negatively affecting the future of the business are taken.

The acquisition is undertaken through a tender offer or private negotiations within the bond markets, if debt instruments are listed, or through private agreements with the borrower for loans, mortgages and non-listed securities. Because the high risk of default and insolvency is reflected into the market price, listed debt instruments trade at a price much lower than the nominal value; analogously privately-placed debt is acquired by the distressed investor at a price which considers the risk of insolvency, the uncertainty in the reorganization process and an adequate expected profit for the investor.

According to Moyer *et al.* (2012), the market price of listed bond issued by distressed firm is lower that its intrinsic value, increasing the potential for profitable investments by distressed or speculative investors. The depression of market prices may be explained by the following reasons:

- asymmetrical information about the actual severity of the distress and the presence of legal procedures:

- illiquidity of the security: the low number of transaction increases the bid-ask spread;
- aversion for speculative instruments: many investors take the commitment to avoid investments in speculative bonds, so they quickly sell their instruments in case of downgrading;
- need of specialized skills and knowledge to profitably invest in distressed bonds
- high riskiness and uncertainty.

From the point of view of the institution selling the debt instruments, "distressed investors are a valuable source of liquidity that enables the original investor […] to reduce their exposure to the often risky process of bankruptcy" (Moyer *et al.* 2012, pages 59-60). After the dismissals of bad credits, the institution recognizes in his profit and loss statement a definitive loss, rather than an uncertain impairment of the claim, which otherwise would be kept in the financial statements until enforcement procedures was pending, and it may lead to additional economic losses. Also, through the selling of distressed claims, lending institutions increase the transparency of their financial statements and they free up capital to be invested in good financial assets.

With respect to small and medium enterprises presenting a situation of financial distress but good perspectives on the side of the operating business, the early intervention by distressed investors helps these businesses to maintain a defined guidance over the ordinary conduct of the operations. In fact, small and medium firms do not possess specific knowledge on turnaround process, thus increasing the severity of the crisis. In case of distress, the refence shareholders have the incentive to leave the guidance of the business operations, since they will not enjoy the eventual value created by their effort.

On the other hand, small and medium firms entertain lending relationships with many banks to satisfy their financial needs, by taking part to several small lending agreements with different lending institutions rather than contracting a big credit facility with a single bank. Although banks perceive a lower credit risk due to the lower exposition, so they favour this practice, they have a low incentive to proper monitor the creditability of the borrower because the loan is small with respect to the scale of the bank's assets and they expect the monitoring is conducted by the other banks. From the lack of incentive to take care about the proper repayment of the outstanding loans, it follows that in case the borrower enters a crisis, banks do not take the effort to sustain the recovery of the business through concession of bridge finance or dilation of payments. Analogously, in case of bankruptcy procedure, the involved banks may refuse to take part to the restructuring to avoid conflicts among institutions and they limit themselves to wait for the distribution of proceeds from dismissal of the overall business or separate liquidation of assets. (Zotti, 2017)

It follows that neither the shareholders nor the financial institutions have the incentive and the power to take decisions oriented to the survival of a small business in a medium-term horizon: the lack of a solid guidance rapidly reduces the residual value. In this scene, the intervention of distressed investors with a clear strategy for the recovery benefits both the non-interested investors, who rapidly recover part of their credits, and the distressed firm, which does not suffer the conflicts among creditors and it can refocus on the operating activity.
Definitively, the presence of distressed investors in financial markets is very likely to positively affect the efficiency of the overall economy since it facilitates the adoption of efficient choices for the recovery of distressed firms rather than prolonging the crisis until it becomes irreversible.

CHAPTER 4 – SEAT PAGINE GIALLE CASE STUDY: ECONOMIC, FINANCIAL AND CORPORATE EVENTS

4.1. PRESENTATION OF THE BUSINESS

According to the information memorandum for the listing of Spyglass S.p.A. on the Italian stock exchange, released to the financial community on 19 December 2003, the core activity conducted by Seat Pagine Gialle (SPG) is based in the Italian market and it belongs to directory segment of media and publishing industry. Its main products are the books Pagine Gialle and Pagine Bianche, released on a district base and updated year by year. These publishing products divulgate the key information, collected from telephone companies and stored in the corporate database, about users of landline phones (name, address and telephone number) within a specific district.

Pagine Gialle product, founded in 1966, is distributed and delivered for free at domicile to all users of landline phones; the book, containing the directory of business users of telephone classified by categories of economic activity they carry on. The classified directory makes Pagine Gialle a useful tool to help the final users to find and put them in contact with the closest artisans, professionals or specialized business able to satisfy their needs. While all the subscribers of non-domestic telephone lines of the district are listed in Pagine Gialle, Seat business model is characterized by the commercial offer to acquire the possibility to highlight their key information or to insert advertising spaces into the pages, to increase the visibility and the knowledge of the businesses among the public.

Pagine Bianche is the historical product of Seat and it consists in a district-based directory of users of landline telephone, both domestics and non-domestics, classified by municipality and following a strict alphabetical order. Pagine Bianche offer provides advertising spaces devoted to businesses, to increase their level of knowledge among the public, and to governmental organizations, to provide useful information to citizens. The publishing of Pagine Bianche is ruled by Italian regulations on telephone services, which obliges the Italian biggest provider of telephone services, Telecom Italia, to distribute the directory to landline telephone users. It follows that Telecom Italia formally acquires the product from SPG at a symbolic price, since the industrial and commercial costs of the publishing are covered by the advertising and Telecom Italia share of price refers to distributional and delivery costs, which are definitively charged to all telephone users through the telephone bill.

From this brief presentation, it is possible to say that the core business of SPG operates in a two-sided market: the generation of revenue is based on the collection of institutional advertising among businesses and governmental organizations, to be delivered to the final users as part of the directory of telephone users. The core asset of Seat is the database of telephone users, which is exploited both as list of potential acquirers of advertising and as final product to be incorporated in the telephone directories. The operating cycle, lasting about less than a year, starts with the orders for advertising space and the definition of the advertisements together with the clients; when the collection of orders is completed, the firm internally defines the layout of directory book, which is printed and delivered to the public through external suppliers. To reduce the operating risks, SPG directly buys in advance the paper it needs from international suppliers and it stores the main raw material in the warehouses of the external printer.

Beside the original business of paper directories, Seat has enlarged its activities in other European countries (Germany, France, Spain) and in the areas of marketing information and in the so-called "directory assistance": the supplying of information upon specific telephone request by the user. Also, to face the change in technology occurred since the 1990s, Seat started to develop digital solutions (CD-ROMs, website) replicating the information of the directories, which played a secondary role with respect to the paper product.

The core business of paper directory has experienced a sudden decline and obsolescence with respect to final users and advertisers since 2005, because of the disruptive innovations from new technologies, especially the diffusion of fixed and mobile Internet connections, the increasing role of search engines as platforms for institutional advertisements and the easy access to information ensured by smartphones. The decline of the core activities on directories caused a sudden reduction in cash flows and Enterprise Value, leading to the need to redefine both the financial structure and the business strategy to ensure the survival of the going concern.

4.2. REMOTE HISTORY

SPG history and its business of telephone directories in Italy take origin in the year 1925, when a corporation called *Società anonima Elenchi ufficiali per gli Abbonati al Telefono* was established in Turin by the local telephone company, *SIP,* jointly with an advertising agency. In 1933, the telephone company *SIP* was affected by the shocks deriving from the 1930s economic crisis and therefore it was acquired by *Istituto per la Ricostruzione Industriale,* the Italian governmental agency established in those years with institutional aim to take intervention into businesses distressed by the crisis and to help the recovery of the overall Italian economy. After the acquisition, Seat became a branch of the sub-holding *STET-Società Torinese per l'Esercizio Telefonico*, a company owned by *IRI* and devoted to control and direction of all the Italian telephone companies acquired by the agency and their related businesses.[1]

In 1996, under the pressure from the European Union to reduce the level of public debt and limit the public intervention in the economy, *IRI* was bound to liquidation and most of its subsidiary businesses were transferred to private owners. Within this context, the directory division of STET was spun-off and incorporated into Seat Pagine Gialle S.p.A., a new corporation with shares listed in the Italian stock exchange with IRI as majority shareholder, to permit the subsequent transfer of the control to private entrepreneurs. [2] In November 1997, the Italian Government sold the controlling stake held through IRI, equal to the 61.27 % of the ordinary capital, to the vehicle *Ottobi,* a consortium of investors formed by De Agostini Group, the financial institutions Banca Commerciale Italiana, Abn Amro, Mediocredito Centrale and Citigroup and private equity funds sponsored by BC Partners, CVC and Investitori Associati. [3]

In 2000, after the concentration of all telephone subsidiaries of STET group in the company Telecom Italia S.p.A., and its subsequent transfer to a group of private investors, the majority stake of SPG was transferred from the consortium Ottobi to Telecom Italia. The acquisition was heavily influenced by the positive momentum of businesses related to internet and new economy, and the strategic rationale was the consolidation of media and publishing activities owned by Telecom Italia to boost their expansion in the internet market. In fact, after the acquisition, Telecom Italia created a new subsidiary named after Seat Pagine Gialle, operating in the traditional directory business, in television business through the channels LA7 and MTV, in web-based services through the brands Virgilio and Tin, and in stationery business through the control of Buffetti Group.

Because of the economic crisis following the burst of Internet bubble in the first years of 2000s, Telecom Italia and minority shareholders suffered spectacular loss on SPG equity value. The subsequent change of future perspective in media and publishing industries led Telecom Italia to the decision to augment its value through the dismissal of business units operating in mature markets and characterized by stable revenues and customers, solid generation of cash and slow growth. At the same time Telecom Italia decided to focus on the business of television publishing and internet advertising. Therefore, Telecom Italia decided to spin-off the business units operating in Directories, Directory Assistance and Business Information from SPG group: after a competitive process, a consortium of private equity firms was interested in the acquisition. Both parties agreed to demerge the company into two corporations: Telecom Italia

[1] http://archiviostorico.telecomitalia.com/sites/default/files/primo%20bilancio%20Stet%201934_0.pdf

[2] http://ricerca.repubblica.it/repubblica/archivio/repubblica/1996/09/14/seat-pagine-gialle-la-stet-ha.html

[3] Report released by the judicial supervisor of composition with creditors of Seat Pagine Gialle S.p.A. and Seat Pagine Gialle Italia S.p.A. ex article 172 of Italian Bankruptcy Code, page 14.

Media, with television, internet and stationery business units, to be retained by the telecommunication company, and a new SPG, controlling the above-mentioned divisions, to be definitively sold.
Please note that in the following parts of the chapter, aimed at the analysis of business, financial and corporate events occurred since 2003 to nowadays, the names Seat Pagine Gialle and Seat or the acronym SPG are always referred to the corporation resulting from this latter extraordinary operation, expressly excluding television and internet operations.
The consortium was formed by four private equity firms, of which three firms had already taken part into Ottobi venture: BC Partners, CVC, Permira and Investitori Associati, through a chain of corporate vehicles specifically established to perform the operation. According to the investment agreement, the above-mentioned spin off was executed on 1 august 2003, then on 8 august 2003 Telecom Italia transferred the 62.5 % of Seat Pagine Gialle S.p.A. shares it owned to the vehicle Silver S.p.A. Then, in compliance to Italian securities law, Silver launched a mandatory tender offer on shares withheld by minority shareholders at a price per share equal to the acquisition price paid to Telecom Italia. The tender offer was accepted by a very small number of shareholders, equal to a percentage of the 0.0263 % of the outstanding ordinary shares.[4] After the conclusion of the tender offer, SPG was controlled by Silver S.p.A., owning the 62.52 % of the outstanding shares, and the remaining 37.48 % was owned by a myriad of small shareholders.
In details, the new corporation SPG, as resulting from the demerger of 1 August 2003, was structured according to three divisions: Directories, Directory Assistance and Business Information. With respect to the core business unit of Directories, Seat used to operate in Italy, United Kingdom and France. Italian operations published and distributed the core products Pagine Gialle and Pagine Bianche, previously described, to 20 million families and to 3 million businesses, vehiculating about 700,000 institutional advertisements per year. Beside the paper edition, the same information about telephone users and advertisers was available also through the CD-ROM editions and specialized websites for both products. Seat published also local maps and useful guides, named after Tuttocittà, and specialized volumes for businesses analysts and purchases managers, whose product names were, respectively, Annuario Seat and Kompass. In United Kingdom, Seat group was the second operator in directories business and it used to publish local directories with the brand Thomson through the subsidiary TDL Infomedia. Through, the local directories, both in paper and web-based version, and the connected service of business information, TDL Infomedia enjoyed the 14 % of UK directories market with about

[4] Information memorandum about the listing of Spyglass S.p.A. on the Italian stock exchange, page 189.

100,000 advertising customers. In France, Seat group used to publish, through the subsidiary Euredit, a European directory of businesses, translated in 16 different languages and distributed at continental level to help the selection of business' suppliers all over the Europe.
Directory Assistance business unit was aimed at the supply of useful telephonic information to final customers through in-bound call centres in Italy, United Kingdom, Germany, Spain and Austria. On the Italian market, directory assistance was constituted by the famous telephone service *89 24 24 Pronto Pagine Gialle*, while non-Italian business units were managed through a Germany-based subsidiary, Telegate A. G., which is listed on Frankfurt stock exchange.
Finally, Business Information unit was referred to the French subsidiary Consodata S. A., controlling operations in Italy, United Kingdom, France, Spain and Belgium. The subsidiary was sold in the first months of 2004 except for the Italian branch of the business unit, withheld at support of the core business. Consodata group provided Marketing services through proprietary and external databases and collection of data about consumption behaviours: information is sold to businesses interested in properly segmentation of potential clients and selection of the target customers.[5]

4.3. INSIDE THE ACQUISITION: BUSINESS STRATEGY

With respect to the acquisition of SPG by the consortium of Private Equity funds, it was motivated by an ambitious plan for growth in revenues and value creation from financial restructuring. In fact, the new owners assumed a relevant growth of revenues and EBITDA on the ten-year period from 2004 to 2014. In this period, they assumed average growth rate in revenues of 4.3 % and average EBITDA growth of 5.5 %. More specifically, revenues had been estimated to pass from 1,609 million Euro in 2004 to 2,418 million Euro in 2014. Similarly, EBITDA had been estimated to double over the period: from 663 million Euro in 2004 to 1,122 million Euro in 2014.
The boost of economic results was explained by an aggressive strategy focused on the improvement of Italian market and abroad expansion. With respect to Italy, planned actions were devoted on the valorisation of the Directories business through incremental innovation on paper products such as higher printing and colour quality, enlargement of the advertisers' base through specific commercial offers for small and medium businesses and increase of efficiency in the selling network and collection of trade receivables. Further positive benefit was expected from the bundling of paper and website advertisings and by the growth on user base on Internet directories and the subsequent appreciation of advertisements on that channel, together with

[5] Information memorandum about the listing of Spyglass S.p.A. on the Italian stock exchange, pages 30-37.

higher expected diffusion of phone directory assistance.[6]

4.4. INSIDE THE ACQUISITION: NON-CONVENTIONAL LEVERAGED BUY-OUT

However, the pillar of the acquirer's strategy to boost Seat Enterprise Value consisted in the modification of the financial structure through an unconventional leveraged buy-out transaction. The starting point was that after the spin-off, SPG presented an equilibrate financial structure, characterized by an amount of financial liabilities, owed to the former owner Telecom Italia, equal to 513 million Euro, to be compared to a book value of shareholders' equity equal to 1,063 million Euro at 30 September 2003. The solid generation of cash due to the stability of the business and the predictability of the revenues stream, together with the planned strategy for growth, would have permitted the creation of further value for shareholders from fiscal shield on interest expenses. The assumption of debt would also permit the alignment of Seat liabilities structure to its international comparable Directories firms.

To implement the acquisition of Seat and the subsequent assumption of financial debt, the private equity funds BC Partners, CVC, Permira and Investori Associati established the following chain of four New Corporations:

- Société de Participations Silver S. A., a Luxembourg-based corporation owned by the participating investment funds, proportionally to their equity contribution in the acquisition, and in minority owned by the new directors' team of Seat
- Sub Silver S. A., a Luxembourg-based corporation totally owned by the former corporation
- Spyglass S.p.A., an Italian-based company totally owned by the former corporation;
- Silver S.p.A., another Italian-based company totally owned by the former corporation.

To undertake the acquisition, private equity funds collectively invested as equity capital a sum equal to 960 million Euro, devoted to the constitution of the chain of vehicles. The ownership shares of the equity stakes into the top NewCo were:

Bc Partners funds	38.04 %
Investitori Associati funds	5.85 %
Permira funds	26.34 %
CVC funds	29.27 %
Other investors	0.05 %

Table 4.1 – Ownership structure of Société de Participations Silver S. A.

Source: Shareholders' agreement on 9 August 2003,
found on http://www.consob.it/web/area-pubblica/quotate/documenti/patti_parasociali/storico/seat2.htm?hkeywords=&docid=0&page=0&hits=80&nav=false

[6] Information memorandum about the listing of Spyglass S.p.A. on the Italian stock exchange, pages 197-200.

The purchase of Seat shares by Telecom Italia was then undertaken by Silver S.p.A. and the respective price of the share package, equal to 3,033 million Euro and corresponding to a price of 0.598 Euro per share [7] was paid through cash obtained by the equity contribution from Spyglass, equal to 874 million Euro, and a bridge loan of 2,207 million Euro provided by The Royal Bank of Scotland – Milan Branch. After the acquisition, the target company, through the intermediation of Silver, negotiated a separate loan with The Royal Bank of Scotland – Milan Branch, to be devoted to the repayment of financial liabilities owed toward Telecom Italia, equal to 513 million Euro.

Rightly after the acquisition by Silver, balance sheets of Seat group and the acquisition vehicles, highlighting their sources of financings, can be resumed in Table 4.2.

			30 September 2003
Sub Silver S.A.			
Assets		Liabilities	
Spyglass shares (100 %)	874	960	Equity capital
Other assets	86		
Total assets	960	960	Total liabilities
Spyglass S.p.A.			
Assets		Liabilities	
Silver shares (100 %)	874	874	Equity capital
Total assets	874	874	Total liabilities
Silver S.p.A.			
Assets		Liabilities	
Seat PG shares (62.52 %)	3,037	832	Equity capital
Cost of financings	17	2,231	Financial liabilities
Current assets and cash	19	10	Other liabilities
Total assets	3,073	3,073	Total liabilities
Seat Pagine Gialle Group			
Assets		Liabilities	
Fixed Assets	1,250	1,063	Equity capital
Net Working Capital	378	565	Net Financial liabilities
Total assets	1,628	1,628	Total liabilities

Table 4.2 – Synthetic Balance Sheets of SPG and the acquisition vehicles at 30 September 2003 Values in million Euro – Personal elaboration from Information memorandum about the listing of Spyglass S.p.A. at pages 173-187 and SPG interim financial statement at 30 September 2003.

[7] Information memorandum about Lighthouse International Company S.A. € 1,300,000,000 8 % Senior Notes Due 2014, found on Thomson Reuters Eikon database, page 39.

As described in Chapter 3, in an ordinary leverage buy-out, after the acquisition, the financial debt is bound to be assumed by the target through the merger by incorporation of the vehicle and the target company. This basic technique was not implemented in Seat acquisition because, despite the vehicle Silver did not own the totality of SPG share capital, the private equity investors were interested in retaining a controlling stake of Seat while keeping it listed on the Italian stock exchange. In fact, a relevant stake of minority shareholders refused the mandatory tender offer and, considering the prevalence of debt in the financial structure of Silver, the eventual merger between Silver and Seat would have caused a relevant dilution of the equity stake of the target owned by the private equity investors.

Therefore, another scheme was implemented to complete SPG leveraged acquisition: the Luxembourg-based vehicle Sub Silver S.A. obtained a short-term credit line of Euro 2,240 million to be devoted to the reimbursement of the debt previously undertaken by the Italian-based vehicle Silver.[8] From the technical point of view, the intermediate vehicle Spyglass increased its equity capital on 15 December 2003: in that date Sub Silver contributed a sum of 109 million Euro as share capital and 2,129 million Euro as share premium reserve. Then, on the same date, Spyglass contributed the sum received by Sub Silver through the previous transaction to its wholly owned subsidiary Silver: the last transaction allowed Silver to totally reimburse in the same date the credit line obtained to execute the purchase of SPG shares, which took place on the same date.[9] The balance sheet of the three vehicles involving into the transaction, as resulting after the increase in equity is resumed in Table 4.3.

			15 December 2003
Sub Silver S.A.			
Assets		Liabilities	
Spyglass shares (100 %)	3,114	960	Equity capital
Other assets	86	2,240	Financial liabilities
Total assets	3,200	3,200	Total liabilities
Spyglass S.p.A.			
Assets		Liabilities	
Silver shares (100 %)	3,114	3,114	Equity capital
Total assets	3,114	3,114	Total liabilities

[8] Information memorandum about Lighthouse International Company S.A. € 1,300,000,000 8 % Senior Notes Due 2014, found on Thomson Reuters Eikon database, page 40.
[9] Information memorandum about the listing of Spyglass S.p.A. on the Italian stock exchange, page 40.

Silver S.p.A.			
Assets		Liabilities	
Seat PG shares (62.52 %)	3,037	3,072	Equity capital
Current assets and cash	53	18	Other liabilities
Total assets	3,090	3,090	Total liabilities

Table 4.3 – Synthetic Balance Sheets of SPG and the acquisition vehicles at 15 December 2003 Values in million Euro – Personal elaboration from the Information memorandum about the listing of Spyglass S.p.A. on the Italian stock exchange at pages 17, 89 and 146.

The following step of the transaction took place on 23 December 2003, and it consisted in the merger by incorporation of Seat Pagine Gialle into Silver and the subsequent incorporation of the resulting company into Spyglass. At the completion of the mergers, Spyglass changed its name into Seat Pagine Gialle S.p.A. and asked the admission of its shares to Milan stock exchange. The previous reimbursement of financial debt undertaken by Silver permitted the execution of the two mergers with an exchange ratio equal to 1, since the two vehicles were completed financed by equity and their assets consisted, directly or indirectly, into SPG shares. The mergers produced the following effects: the controlling shareholder Sub Silver S. A. became the owner of the 62.52 % of the operating company, at the same time minority shareholders were not substantially affected by the mergers, while accounting balance sheet of the operating company was relevantly modified. In fact, the mergers permitted the recognition, in the accounting books of the resulting company, of the difference between the accounting value of shareholders equity of the operating company after the demerger, equal to about 1,063 million Euro at 30 September 2003, and the economic value of its equity capital as resulting from the financial markets. The two mergers originated both cancellation deficit and exchange surplus: the former corresponded to the differences between the accounting value of the former Seat equity, and the historical cost of Seat shares registered on the asset side of the vehicles' balance sheets, referred to the economic value of the majority stake. At the same time, the latter correspond to the difference between the nominal value of equity belonging to shares issued to minorities and the accounting value of the minority shares of equity capital of the incorporated subsidiaries. In the balance sheet of the firm resulting from the merger, cancellation deficits and exchange surpluses were booked as goodwill, in the asset side, and as disposable share premium reserve in the liability side. (Potito, 2009)

As a result, consolidated Balance sheet of Seat and Sub Silver at 31 December 2003 are represented by Table 4.4.

			31 December 2003
Sub Silver S.A.			
Assets		Liabilities	
Seat PG shares (62.52 %)	3,114	960	Equity capital
Other assets	86	2,240	Financial liabilities
Total assets	3,200	3,200	Total liabilities
Seat Pagine Gialle Group			
Assets		Liabilities	
Goodwill	3,183	4,374	Equity capital
Fixed Assets	1,430	460	Net Financial liabilities
Net Working Capital	221		
Total assets	4,834	4,834	Total liabilities

Table 4.4 – Synthetic Balance Sheets of SPG and the acquisition vehicles at 31 December 2003 Values in million Euro – Personal elaboration from balance sheets attached to Information memorandum about the listing of Spyglass S.p.A. on the Italian stock exchange and SPG restated financial statement at 31 December 2003.

The last step of the leveraged transaction was the distribution of an extraordinary dividend to the shareholders, to allow the repayment of the credit line obtained by Sub Silver S. A. and the assumption of financial liabilities by the operating firm. The distribution of the extraordinary dividend was approved by Seat shareholders meeting on the 15 April 2004 and paid on 22 April 2004 for a total amount of 3,578 million Euro, equal to 0.43 Euro per share.[10]

Rightly before the distribution of the extraordinary dividend, on 14 April 2003, Sub Silver divested part of SPG shares it held, equal to a percentage of 12.38 % of equity capital. After the transaction, Sub Silver held the 50.14 % of Seat equity capital, slightly higher than the minimum stake necessary to control the shareholders' meetings through the majority of voting rights. The shares were sold to the investment bank Lehman Brothers, which had taken part in the definition of the leveraged transaction and the financial structure, at a price equal to 0.80 Euro per share, corresponding to total proceeds of about 804 million Euro and capital gain of 187 million Euro, since the accounting value of the divested equity stake was equal to 617 million Euro [(3,114 / 62.52 %) * 12.38 %]. Lehman Brothers immediately sold the shares acquired in the open market, while Sub Silver S. A. devoted a sum of 451 million Euro to the partial reimbursement of the bridge loan.[11]

According to the shareholding structure resulting after the partial divestment, the extraordinary

[10] SPG financial statements – fiscal year 2003.

[11] Information memorandum about Lighthouse International Company S.A. € 1,300,000,000 8 % Senior Notes Due 2014, found on Thomson Reuters Eikon database, pages 7-8.

dividend received by the controlling shareholder Sub Silver S. A. was equal to 1,794 million Euro; at the same time minority shareholders collectively received a sum of 1,784 million Euro. The dividend paid by Seat to the controlling shareholder Sub Silver was almost equal to the principal amount of the remaining financial loan after the above mentioned: in fact, the residual principal was about equal to 1,789 million Euro (2,240 – 451). At the end of these complex operations, the vehicle Sub Silver withheld an amount of liquidity equal to 2,147 million Euro, resulting from the extraordinary dividend plus residual proceeds from the divestment of Seat shares (1,794 + 804 – 451). Assuming the total reimbursement of the principal, Sub Silver obtained an estimated net generation of cash close to 358 million Euro (2,147 million – 1,789 million), corresponding to the 37 % of the sum initially contributed by private equity investors in the acquisition. The income obtained by Sub Silver is estimated in 1,981 million Euro, corresponding to the sum of received dividend and capital gain from partial divestiture (1,794 + 187). Please note that estimated income and cash generation does not include financial expenses on the credit line and transaction costs.

SPG and Sub Silver balance sheets at 30 June 2004, as resulting from the distribution of the extraordinary dividend, are the following.

			30 June 2004
Sub Silver S.A.			
Assets		Liabilities	
Seat PG shares (50.14 %)	2,497	960	Equity capital
Liquidity	2,147	1,981	Income
Other assets	86	1,789	Financial liabilities
Total assets	4,730	4,730	Total liabilities
Seat Pagine Gialle Group			
Assets		Liabilities	
Goodwill	3,183	708	Equity capital
Fixed Assets	1,325	3,967	Net Financial liabilities
Net Working Capital	167		
Total assets	4,675	4,675	Total liabilities

Table 4.5 – Synthetic Balance Sheets of SPG and the acquisition vehicles at 30 June 2004
Values in million Euro – Personal elaboration from Information memorandum about Lighthouse International Company S.A. € 1,300,000,000 8 % Senior Notes Due 2014, found on Thomson Reuters Eikon database and interim financial statement of SPG at 30 June 2004

After the payment of the extraordinary dividend, the definitive long-term financial structure of SPG was set according to of the financial term sheets. Financial liabilities were regulated by an agreement with The Royal Bank of Scotland – Milan branch, providing a financial loan with floating rate of total 2,900 million Euro and 75 million Pounds, divided in the following tranches:

- 1,250 million Euro to be repaid in six-month instalments, until June 2010
- 750 million Euro to be repaid half in December 2010 and half in June 2011
- 750 million Euro to de repaid half in December 2011 and half in June 2012
- 75 million Pound devoted to the anticipated reimbursement of financial bonds issued by the British subsidiary TDL, with expiration in 2009
- 150 million Euro in the form of revolving credit line to finance eventual needs for Working Capital

The second pillar of the financial structure was a subordinated debt negotiated with an *ad hoc* Luxembourg-based vehicle, called Lighthouse International Company S. A.: this vehicle collected financial resources through the issuing of high-yield bonds and then it lent to SPG an amount of 1,300 million Euro at 8 % interest rate: the coupon was due on six-month time basis, while the principal was due in bullet on April 2014.
The financial loan with The Royal Bank of Scotland was guaranteed by the following collaterals issued by the operating firm:

- Pledge on Pagine Gialle and Pagine Bianche trademarks
- Pledge on SPG bank accounts
- Transfer of SPG trade receivables
- Pledge on share of SPG's foreign subsidiaries
- Pledge on SPG's intercompany loans
- Privilege on SPG fixed assets with book value not lower than Euro 25,000

Furthermore, the loan was collateralized by Sub Silver S. A., granting a pledge on its majority stake of SPG shares, and by Société de Participations Silver S. A., who pledged its share of the vehicle Sub Silver S. A. At the same time, the subordinated loan was collateralized by SPG, Sub Silver and Société de Participations Silver in favour of Lighthouse bondholders with guarantees subordinated to the prior satisfaction of the obligation arising from the senior loan.
It must be noted that the residual book value of shareholders' equity, as resulting from the balance sheet on 31 December 2004, was equal to 675 million Euro, to be compared with its former amount of 4,374 million Euro before the distribution of the extraordinary dividend.

4.5. OPERATING AND FINANCIAL PERFORMANCE FROM 2004 TO 2007

Relevant financial data of period examined in this paragraph, as resulting from official SPG financial statements, are resumed in Table 4.6.

	2004 (IAS)	2005	2006	2007	2008
Revenues	1,410.1	1,430.6	1,468.8	1,449.6	1.375,0
YoY Growth	-2.86%	1.45%	2.67%	-1.31%	-5.15%
Core Revenues	1,059.7	1,061.8	1,077.5	1,090.2	1,058.7
EBITDA	614.4	626.6	611.2	648.1	602.7
Marginality	43.6%	43.8%	41.6%	44.7%	43.8%
EBIT	379.3	420.2	402.1	427.7	228.3
Profit/Loss	86.1	138.7	81.8	106.2	(173.7)
Equity	860.0	999.7	1,075.4	1,123.8	903.5
Liabilities	4,533.0	4,317.3	4,152.1	3,981.9	3,901.3
Intangible Assets	4,342.7	4,199.0	4,064.9	4,035.0	3.613.8

Table 4.6 – Highlights of financials for fiscal years 2004-2008 – Values in million Euro
Source: SPG official financial statements; 2004 values are taken from 2005 financial statement

After the completion of the leveraged transaction, the economic performance of fiscal year 2004 presented a decline in revenues of -2.86 % with respect to pro-forma data of year 2003, compensated by the improvement of EBITDA which grew on a 2 % rate. The economic result of year 2004 was characterized by a loss of 112 million Euro, which is attributable to the application of accounting principles prescribed by the Italian Civil Code, requiring the systematic amortization of book value of goodwill on a 20-year time basis. From the fiscal year 2005, SPG was obliged by European regulations to adopt IAS-IFRS accounting principle, which required the impairment of goodwill only in case of loss on value as resulting from the yearly impairment test. Therefore, new regulations required Seat to reperform 2004 financial statements according to the new IAS-IFRS accounting principles, and the reperformed profit and loss statement presented a positive result of 86.1 million Euro.

The economic performance of year 2005, resulting from new financial statements compliant with IAS-IFRS principles, was characterized by the following growth rates: revenue growth of 1.45 %, EBITDA growth of 1.98 % and positive economic result equal to 138.7 million Euro: the positive result permitted the distribution to shareholders of 42 million Euro as ordinary dividends. The growth in revenues was not sustained by the operation in Italian Directories (labelled as “Core Revenues” in Table 4.6), which generated a level of revenues almost equal to the precedent year. In detail, revenues from advertisements on paper products presented a small decline, which were compensated by the increase in revenues from web and voice products. By contrary, UK Directories and Directory Assistance business units, presented increases in revenues and EBITDA levels. Directory Assistance business unit, in 2005 enlarged its operations in France, trying to take advantage from new European rules aimed at higher level of competition on directory assistance services. With respect to accessory business units, in 2005 SPG acquired an Italian firm, Cipi, operating in the market of promotional gadgets, to enlarge its commercial offer.

With respect to financial liabilities side, in 2005 Seat reached an agreement with The Royal Bank of Scotland aimed at refinancing and rescheduling the financial debt. As a result, at the end of year 2005, the senior debt was articulated as following:

- Tranche A, equal to 1,930 million Euro, due in six-month instalments from June 2006 to June 2012
- Tranche B, equal to 600 million Euro, expiring in June 2013
- Tranche C, a revolving short-term credit line to cover financial need originated from increase in Net Working Capital.

The solid generation of cash originated by ordinary business operations of SPG allowed the anticipated reimbursement to RBS of 94 million Euro and the negotiation of more favourable spreads on Euribor interest rate at the basis of the computation of financial expenses.

Then, 2006 fiscal year was characterized by quite positive results: revenues equal to 1,469 million Euro, with growth rate of 2.67 %, EBITDA equal to 611 million Euro, presenting a decline of -2.45 % on year 2005, net earnings equal to 82 million Euro. In 2006 too, positive profit and cash generation allowed the distribution of a total sum of 58 million Euro as ordinary dividends. Into details, revenues of Italian directories business unit experienced a growth of 1.5 %, driven by the rise of web and telephone services which compensated the reduction of revenues of paper products. Directory Assistance business unit achieved positive results, especially in Spanish, French and Italian market, while during the year it stopped its operations in the Austrian market. With respect to Italian market, the division opened the new service *12 40 Pronto Pagine Bianche,* exploiting the opportunities from liberalization of directory assistance service for private telephone users. The new service presented rapid growth rate, sustained by a massive advertising campaign. By contrary, UK Directories business unit experienced the decline in revenues level of -1.2 % and the contraction in EBITDA.

From the financial side, SPG realized the securitization of trade receivables, by transferring them to a Special Purpose Vehicle, which collected among institutional investors 256 million

Euro to pay the discounted value of receivables to Seat. From the accounting point of view, financial liabilities of the Special Purpose Vehicle toward external investors are included into Seat consolidated balance sheet in compliance with the applicable accounting standards, because of credit risk on trade receivables was not transferred to the vehicle. The liquidity obtained by Seat as proceeds from the securitization were devoted to the senior lender RBS as partial anticipated extinction of the financial loan. In the same year, SPG entered into a financial leasing agreement finalized to the restructuring and the acquisition of a real estate complex in Turin as new seat for the corporate headquarter.

The 2007 fiscal year experienced a slightly decline of revenues of -1.31 % but substantial growth of the EBITDA of 6.03 %, which reached the level of 648 million Euro; the net result was positive and equal to 106 million Euro. Despite the positive profit, corporate directors deny distribution of ordinary dividends to strengthen the financial structure. While revenues from the core division experienced a growth of 1.2 %, the accessory business units presented a decline in revenues. In fact, revenues from UK Directories declined of 8.4 %, Directory Assistance division shrank by 1.5 % because of decline in French and German operations. With respect to extraordinary transactions, year 2007 was characterized by the acquisition from the Swedish directory publisher Eniro of the German-based company Wer Liefert Was; also, Seat entered in the Turkish market of media and internet through the establishment of a joint venture with a local partner.

From the corporate point of view, the market performance on the stock exchange of SPG shares experienced a relevant decline of about 40 %, moving from 0.45 Euro per share at January 2007 to 0.27 Euro at December 2007, following negative market expectations from the US crisis of subprime mortgages, the market riskiness of media industry and the financial risk originated by the high debt level. The volatility of the share was influenced also by the decision taken by the private equity funds which controlled the majority of Seat to divest their position. The decision was officially assumed in May 2007 through the hiring of a primary investment bank, but it was soon retired in October 2007 because of the weakness of financial markets and the difficulty in realizing a profitable sale.

4.6. DECLINE AND FINANCIAL DISTRESS FROM 2008 TO 2010

Relevant data of SPG financial statements from year 2008 to year 2010, which showed the first signals of financial disequilibria and represented the entry of the business into a phase of decline, resulting from downturn and deterioration of the core business of traditional directories, are resumed in Table 4.7.

	2007	2008	2009	2010	2011
Revenues	1,449.6	1.375,0	1.214,5	1.039,2	961,8
YoY Growth	-1.31%	-5.15%	-11.7%	-14.4%	-7.45%
Core Revenues	1,090.2	1,058.7	952.2	797.5	748.5
EBITDA	648.1	602.7	527.6	416.5	370.6
Marginality	44.7%	43.8%	43.4%	40.1%	34.7%
EBIT	427.7	228.3	245.7	(374.8)	(433.0)
Profit/Loss	106.2	(173.7)	(35.6)	(716.9)	(789.0)
Equity	1,123.8	903.5	1,039.3	228.7	(555.1)
Liabilities	3,981.9	3,901.3	3,530.5	3,613.0	3,481.8
Intangible Assets	4,035.0	3.613.8	3,428.6	2,728.4	2,019.0

Table 4.72 – Highlights of financials for fiscal years 2007-2011 – Values in million Euro
Source: SPG official financial statements

In details, weak performance of year 2008 was also a consequence of result of decline in the overall advertising market originated by deep economic and financial crisis which hit the whole European economy; therefore, revenues declined by 5.15 % and EBITDA declined by 7 %, reaching an absolute level close to the threshold of 600 million Euro. The main business unit of Italian directories declined in revenues by 2.9 %, while revenues from the respective UK operations decreased of 25.3 %, including the effect of the foreign currency. By contrary, Directory Assistance business experienced a growth of 2.5 % because of the acquisition of a German subsidiary, operating in the market of on-line advertising, aimed at the obtainment of positive synergies with the existing German branch and at the revitalization of the division.

The negative perspective was reflected in the negative result of the yearly impairment test on goodwill and intangible assets, which led to the accounting recognition of 130 million Euro of impairments related to the subsidiaries TDL Infomedia, Europages and Cipi. Moreover, on 23 December 2008, the German subsidiary Wer Liefert Was was rapidly dismissed from the group with a definitive loss of 79 million Euro. The impairment of goodwill and the negative result from the dismissals originated a negative result on the consolidated profit and loss statement equal to 173 million Euro.

While obligations arising from financial debt had been regularly satisfied, since the total amount of financial debt at the end of year 2008 reduced to about 3,048 million Euro, the combined effect of deterioration in business perspectives, expected reduction in marginality and cash flow generation, together with decision to implement a new business strategy since 2009 originated the need to undertake a process of restructuring both in business operations and in financial structure.

4.6.1. Year 2009: Increase in share capital and new business plan

Therefore, in January 2009 SPG, its controlling shareholders and The Royal Bank of Scotland reached an agreement on the modification of previously negotiated covenants regarding the senior loan, to adapt the financial constraints to new business scenarios. As counterparty for the covenants resetting, the senior lender asked Seat to strengthen the financial structure through an increase in share capital of 200 million Euro and the subsequent advanced reimbursement of 100 million Euro with the proceeds from equity injection. Together with the covenant resetting, the spread on the Euribor rate was increased by 75 basis points, and the lender required the express commitment by controlling shareholders to exercise their option right on equity and to invest their proportionate share of 100 million Euro. On this point, the vehicles referred to the private equity firm BC Partners refused to participate in the equity injection and its option rights were transferred and exercised by the private equity funds CVC and Investitori Associati, who increased their participation stake in Seat share capital.
Since the negative performance of financial and equity markets, which reflected the uncertain perspectives of the worldwide economy, conflicted with the urgency of Seat to collect equity capital and to honour the agreement with the lender, increase in share capital was characterized by an extremely high dilution ratio in the issuance of option rights to existing shareholders. In fact, before the increase in share capital existing shares were grouped according to the ratio of 1 new share per 200 old shares, then, at the execution of the equity injection, shareholders had been given the option right to subscribe 226 new shares each 5 existing shares after the grouping. In this way, shareholders who did not exercise their option rights would have borne a dilution of their position by 97.84 %: in the hypothesis of complete subscription of the whole new equity by new investors, only theoretical because of the commitment of private equity funds to fully subscribe their proportionate share of equity, former shareholders would have collectively held only the 2.183 % of outstanding shares after the equity subscription.
The above-described scheme constitutes a hyper-dilutive increase of capital, characterized by the assignment of a big number of option rights per existing share, and it was first implemented within the Italian stock exchange for this equity offer. The setting of such dilution ratios was aimed at augmenting the attractivity of the offer and to ensure the success of the transaction, in a generalized context of financial and economic crisis. From Seat point of view, the success of the increase of capital conditioned its vital perspectives: in case the equity injection failed, the

lender would not have granted the covenant reset, and the firm would have been in default.
From the financial point of view, when an increase of capital with option rights starts, the option right, formerly incorporated into the share, is divided from the share and it is separately tradable in the stock exchange within a certain time window. During this time window, investors have an arbitrage opportunity, since the *ex*-price of the outstanding shares (resulting from the definitive separation of the option right) shall be equal to the current option price plus the subscription price, formerly fixed by the issuing company. Therefore, when option is tradable, its equilibrium price is computed according to the following formula:

$$Option\ Price = (Share\ price - Subscription\ price) * Dilution\ Ratio$$

It must be remembered that at the end of the time window for option rights negotiation, the owner of the option has the faculty, not the obligation, to pay the subscription price and obtain new shares, otherwise the option expires without any consequences. The market reacted with a strong growth of *ex*-price of the share in the first days of separate trading of options, while the option prices reflected prices before the opening of subscriptions. Because of the high positive spread between prices of existing shares and options rights, the latter were deeply in-the-money and their holders were forced to exercise the option, subscribing the new equity and obtaining new shares, under the expectation to sell the shares and to profit from the position. The result was that during the exercise period, share prices doubled or even tripled day by day, moving from the initial price of 0.24 Euro to a maximum price of 1.04 Euro. It was clear that Seat securities were affected by a bubble, which burst right after the conclusion of the time window, falling a price of 0.17 Euro.
However, from Seat point of view, the technique was very successful, since at the end of time window for exercise of the option the 98.71 % of option rights had been exercised; then the small unexercised options, although the subscription was guaranteed by the private equity funds, were offered in a public auction through the Stock Exchange and finally they were fully exercised. (Mantegazza 2009-2010)
In the meantime, with respect to the operating side of the business, the management approved a new business plan focused on the development of internet-based marketing and advertising services. About the historical business line of directories, the plan was aimed at the sustainment of revenues from traditional products, through offers bundling on-line plus paper products for Small and Medium Enterprises. With respect to on-line products, Seat plans included the creation of websites and services for visibility on web search engines, the latter developed since March 2009 through a reselling agreement with Google. The management decided also to exit from French and Turkish operations belonging to the Directory Assistance business unit. The

change in strategy was motivated by the technological change and different availability of information to final users of directories, together with contraction in the market of advertising and the general crisis of publishing and media industry.
It must be highlighted that in 2009 Seat experienced the substitution of its Chief Executive Office: on 29 April 2009 the Board of Directors accepted the resignation of Luca Majocchi, the CEO who guided Seat since the acquisition by private equity investors in 2003; its position was taken by Alberto Cappellini, with the mandate to transform Seat and implement the new strategy focused on the supply of web-based marketing services.
Despite the approval of the new business plan, economic and financial results of 2009 were characterized by reduction in revenues of 11.7 % and reduction in EBITDA of 12.4 %: their monetary amount were respectively 1,214 million Euro and 528 million Euro. In line with the new strategy, web-based services increased their diffusion among customers, but revenues of the overall business unit of Italian Directories fell by 10 % and became lower than 1,000 million Euro. Furthermore, revenues originated from UK Directories decreased by a rate of 31 %, which included the negative consequence of currency depreciation. Also, UK operations were involved in the restructuring of the pension funds for local employees, which presented financial disequilibria. Net result of the overall Seat group presented a loss of 35 million Euro, affected by the impairment of goodwill and intangible assets for 91 million Euro.

4.6.2. Year 2010: Emission of Senior Secured Bonds

In 2010, generalized financial crisis, low aggregate expense on advertising by business, and decline in attractiveness of traditional paper products contributed to the continuation of reduction in revenues. Total revenues were equal to 1,039 million Euro, presenting a decline of 14.43 % with respect to the previous year. EBITDA was equal to 416 million Euro, declining by 21 %: consequently, directors impaired goodwill value by an amount of 674 million Euro. The impairment, almost entirely attributed to goodwill referred to Italian Directories business unit, reflected the deterioration of future perspectives predicted by external equity analysts in term of negative long-term growth rate and higher discount rate, and the high risk of refinancing outstanding debt. The impairment heavily affected the profit and loss statement, which closed with a loss equal to 716 million Euro. Consequently, book value of shareholders' equity was reduced to an amount of 229 million Euro.
With respect to Seat operating performance, Italian Directories revenues were equal to 797.5 million Euro: inside the division, traditional products declined by 7 %, while internet products grew by 36.7 %. Revenues from UK directories declined by 13.3 %, and revenues from Directory Assistance declined by 14 %, because of the dismissal of two Italian call centres.

Please note that economic and financial data for fiscal year 2010 presented in the paragraph have been taken from figures reperformed in 2011 financial statement for sake of continuity with future data. As it will be explained in Chapter 5, the reason is that since 30 June 2010, SPG changed its accounting criteria for recognition of revenues in its profit and loss statement, to reflect the predominance of internet advertising services, provided on a continual time basis, on traditional paper publishing, so figures are not fully comparable with 2009 performance.
Moving to the financial situation, it resulted that Seat was asked to completely reimburse outstanding financial debt on a four-year time horizon. In fact, according to information disclosed in 2008 and 2009 financial statements, after the covenant resetting and increase of capital in year 2009, Seat was obliged to repay about 240 million Euro per year in 2010 and 2011, plus an amount of 560 million Euro in 2012 as complete reimbursement of the Tranche A. Moreover, in 2013 Tranche B would have expired for an amount of 470 million, and in 2014 it would have been the turn of the Lighthouse bond, with a principal of 1,300 million Euro.
Unfortunately, the continual deterioration of revenues and EBITDA levels from years 2008 to 2010 was reflected in the reduction of cash generation, putting a threat on the firm's capability to honour the expiring obligations on repayment of principal and interest of the financial loans. The disequilibria in the financial structure were recognized by rating agencies Standard & Poor's and Moody's, which downgraded the corporate rating to B- in November 2010.
For all these reasons, with the help of primary investment banks, SPG conducted negotiation with the senior creditor, The Royal Bank of Scotland, for the refinancing of the debt structure. The parties agreed on the issuance of long term bond loans whose proceeds had been devoted to anticipated reimbursement of the senior loan and resetting of financial covenants; because of the higher riskiness of the original loan, Royal Bank of Scotland increased the spread by other 75 basis points for the residual amount of the principal. Through the bonds, Seat refinanced its senior debt by deferring the obligation to reimburse the principal to year 2017. Therefore, the first bond loan was issued at a nominal amount of 550 million Euro, nominal interest rate of 10.5 % and expiration date on 31 January 2017. The bond loan was bought by investors below the par value, allowing Seat to collect 536 million Euro at an actual interest rate of 11 %, and it permitted the reimbursement to RBS bank of 507 million Euro, as partial repayment of the Tranche A of the senior loan. At the end of the year, Seat issued another bond loan, with nominal amount of 200 million, nominal interest rate of 10.5 % and expiration date on the 31 January 2017. The result of the issuance was worse than the first bond, with a collection of 180 million Euro (90 % of the nominal) at an actual interest rate of 12.85 %. After the collection of proceeds, The Royal Bank of Scotland obtained the advance reimbursement of 172.4 million Euro.
Both senior bonds were guaranteed by the same set of collaterals secured in favour of Royal

Bank of Scotland, except for the privilege on fixed assets with book value not lower than 25,000 Euro. So, bond holders received specific real guarantees provided by Seat itself on Pagine Gialle and Pagine Bianche trademarks, on the shares of the subsidiaries Thomson Group and Telegate, plus pledges on assets withheld by the vehicles of the controlling shareholders, especially on their controlling stake of SPG shares. According to a specific Intercreditor Deed, it was agreed with The Royal Bank of Scotland that obligation arising from the bonds had the same priority levels with respect to the senior loan: proceeds from the eventual enforcement of collaterals should be distributed to bond holders and senior lenders proportionately to the nominal amount of the principal due.[12]

Though this transaction, Seat was able to refinance almost half of its outstanding debt with The Royal Bank of Scotland, by reducing its obligation to repay the principal for years 2011, 2012 and 2013 from 1,265 million Euro, computed according to the previous lending agreement, to 666 million Euro computed at 31 December 2010. The refinanced debt was transformed in long-term obligation, with a six years maturity. As a counterpart, the refinancing generated the rise in the cost of debt, from the average level of 5.8 % in 2009 to 7.6 % at the end of 2010, which reflected the riskiness of the big debt burden, the worldwide financial crisis and the weakness of Seat capability to generate strong and sustainable cash flows.

4.7. YEARS 2011-2012: RESTRUCTURING OF JUNIOR DEBT

After the conclusion of the emission of the Senior Secured Bonds in 2010, continual reduction of revenues and the deterioration of market performance forced Seat management to open a phase of negotiation with overall involved stakeholders to achieve a restructuring of the financial structure, to increase its solidity in a long-term horizon. The necessary financial and business advisors were hired in March 2011, and after the obtainment of the necessary formalities, Seat opened the negotiation with representatives of controlling shareholders and involved creditors, grouped in three committees: Bondholders committee, referred to the Lighthouse subordinated bonds, Senior committee, referred to bonds issued in 2010 and the Senior Creditor, The Royal Bank of Scotland. Seat management, supported by its advisors, proposed the conversion in equity capital of the subordinated loan obtained by Lighthouse bondholders, whose definition of details required long negotiation among involved stakeholders before their representatives granted their definitive approval. The final term sheet of restructuring was approved by Seat on 31 January 2012, and it was characterized by numerous legal and technical step for its implementation, since the restructuring was subject to British,

[12] Information memorandum on Seat Pagine Gialle € 550,000,000 10.5% Senior Secured Notes Due 2017, found on Thomson Reuters Eikon database, page 101.

Luxemburg and Italian jurisdictions. The restructuring was aimed in causing a deep modification in ownership structure and financial structure, according to the following paragraphs which resume the articulated content of restructuring.

First, financial claims held by Lighthouse bondholders were converted into ordinary shares of the issuing vehicle, Lighthouse International Company; then, Seat subordinated financial liabilities toward Lighthouse were bound to be cancelled through the merger by incorporation of Lighthouse into Seat and the contemporaneous extinction by confusion of the claim. As counterparty for the write-off of that financial liability, Lighthouse bond holders obtained the majority stake of the corporation resulting from the merger. More specifically, it was negotiated that after the merger, Lighthouse bondholders were given the 88 % of the share capital of the resulting company, while the former shareholders, including the private equity funds, retained the 12 % of the equity stake. For sake of precision, bondholders were given the 90 % of the shares, but at the same time incumbent shareholders received an equity warrant with symbolic strike price, which consented the immediate subscription of a percentage of shares equal to the 2 % of equity capital. The nominal amount of Lighthouse bonds converted into equity was 1,235 million Euro, and the residual debt of 65 million was converted into a new tranche of senior bond loan with the same contractual conditions and expiration date as the other two senior bond loans.

Moving to the senior components of Seat financial structure, the outstanding loan with The Royal Bank of Scotland, previously due in 2012 and 2013, was modified into a unique credit line of 596 million Euro with expiration date on the 30 June 2016 and increased spread on Euribor rate equal to 5.4 %. Pre-existing senior bond loans were kept unchanged. At the end of the transaction and considering the positive effect of cash flows generated by business activities, net financial liabilities declined from 2,736 million Euro at the end of 2011 to 1,328 million Euro at 31 December 2012.

Financial liabilities were assisted by a guarantee on Seat assets, issued through the total contribution of overall assets and liabilities of Seat Pagine Gialle S.p.A. to a non-operating wholly owned subsidiary, Seat Pagine Gialle Phone Services S.r.l. After the contribution, the name of the subsidiary changed into Seat Pagine Gialle Italia S.p.A., and all its shares had been pledged in favour of senior bondholders and senior lender on a *pari passu* basis. The contribution produced the effect that, in conformance with Italian Civil Code, SPG and SPG Italia were joint and severally liable for obligations arising from lending agreements towards RBS bank and Senior bondholders. SPG became a holding company devoted to the management of its unique asset, the total share capital of the subsidiary which effectively carried on the overall business activities. The constitution of SPG Italia was negotiated to compromise the interest of senior creditors, who requested a guarantee on Seat property rights of equity capital, with interest of subordinated bond holders, who collectively asked to receive shares free from liens and encumbrances, together with the continuation of their listing in Milan Stock Exchange.

The proposal was formally accepted by all involved stakeholders in March 2012 and the consent started the execution of the required legal and technical procedure, including the opening of a bankruptcy procedure called "administration" under British jurisdiction to permit the conversion of Lighthouse bonds into Lighthouse shares. The formal approval of the merger between Lighthouse and Seat was obtained on the 12 June 2012 by Seat extraordinary shareholders' meeting, and the transaction was completed on the 1 September 2012 with the execution of the merger and the subsequent contribution of assets to the new operating company.

The restructuring procedure was conducted under the legal protection of the Certificate Plan ruled by article 67 paragraph 3 letter d of Italian Bankruptcy Code: SPG obtained a certification by Prof. Lorenzo Pozza about the susceptibility of the complex set of transactions to restructure the outstanding debt and to reduce the unsustainable debt exposure, aimed at the prevention of legal challenges in case of subsequent insolvency procedures. After the completion of the equitization, shares were mainly in the hands of four distressed investors, who had collected the Lighthouse bonds before the equitization and controlled a comprehensive stake of 39.79 % of outstanding shares. New shareholders nominated a new Board of Directors with Chairman Guido De Vivo and Chief Executive Officer Vincenzo Santelia. On this point, it is important to clarify that in the meantime of the restructuring procedure, the Chief Executive Officer seat remained vacant since the end of March 2012, because of the sudden death of Mr. Alberto Cappellini.

4.7.1. Operating and financial performance

This paragraph presents economic and financial data from SPG official financial statements issued in the years of the out-of-court restructuring, resumed as usual in Table 4.8.

	2010	2011	2012	2013
Revenues	1.039,2	961,8	808,8	507.9
YoY Growth	-14.4%	-7.45%	-15.9%	-22.9%
Core Revenues	797.5	748.5	626.7	475.1
EBITDA	416.5	370.6	296.0	89.5
Marginality	40.1%	34.7%	36.6%	17.6%
EBIT	(374.8)	(433.0)	(1,754.9)	(234.4)
Profit/Loss	(716.9)	(789.0)	(1,049.6)	(347.8)
Equity	228.7	(555.1)	(968.2)	(1,323.4)
Liabilities	3,613.0	3,481.8	2,130.0	2,164.0
Intangible Assets	2,728.4	2,019.0	416.8	130.3

Table 4.8 – Highlights of financials for fiscal years 2010-2013 – Values in million Euro
Source: SPG official financial statements

In details, year 2011 financial statements, which did not consider the effect of the Lighthouse restructuring under negotiation, are characterized by the decline of relevant financial data: total revenues declined by 7.45 % and its amount was below the billion threshold, equal to 962 million Euro, while EBITDA declined by 11 %, reaching an amount of 372 million Euro. The performance of Italian directories business unit was equal to 748.5 million Euro, shrinking of 6.1 % with respect to the previous year, despite the increasing in diffusion of new Internet-based marketing services. Also, other business units presented declining revenues equal to 17.3 % for UK Directories and 14.8 % for Directory Assistance.

2011 profit and loss statement was characterized by another relevant impairment of goodwill per an amount of 696 million Euro, which determined an overall net consolidated loss of 789 million Euro. From the balance sheet point of view, the relevant loss led to the complete erosion of the book value of shareholders' equity, which presented a negative value of 555 million Euro at 31 December 2011.

In 2012, revenues presented a decline of 15.5 % with respect to year 2011, reaching the level of 808 million Euro, and EBITDA was equal to 296 million Euro, presenting a contraction of 20 %. The main business unit, Italian directories, reduced its revenues of 16.3 %: the decline was experienced by both traditional services and new web marketing services. According to the financial statement, the decline of Seat core business was determined by a generalized reduction of advertising expenses in the Italian market which impacted Seat turnover since 90 % of revenues were originated from the supplying of advertising services. In addition, in 2012, Seat experienced high churn rate of clients determined from the cessation of the policy, adopted in the previous year, of renewal of annual advertising agreements before the natural expiration at lower price. The advanced renewal of agreements produced the partial recognition of revenues for services to be offered in 2012 in the previous year, deepening the revenues decline in 2012. Revenues from UK Directories business unit declined by 6.2 % because of natural decline of paper products and the stable performance of internet products. Directory Assistance division experienced a reduction of revenues of 15.8 % because of the continual decline of interest and utilization of the service.

At the light of the general decline of all products and services offered by SPG and the situation of financial distress which required the heavy restructuring of financial liabilities, the economic result of Seat is heavily impacted by the almost total impairment of goodwill and intangible assets, per an amount of 1,887 million Euro. In addition, in 2012 Seat sustained extraordinary expenses for the complex equitization of Lighthouse bonds per an amount of 68 million Euro, of which 43 million Euro in the interest of financial creditors. As counterparty, the restructuring determined a positive income of 670 million Euro resulting from the writing-off of a corresponding amount of financial liabilities. The bottom line of 2012 profit and loss statement presented a loss of 1,050 million Euro, determining a negative book value of shareholders' equity equal to – 968 million Euro and requiring the adoption of additional extraordinary measures to restore the economic and financial equilibrium.

4.8. YEARS 2013 – 2014: COMPOSITION WITH CREDITORS

After the conclusion of the financial restructuring and the entry in charge of new Directors, between November 2012 and January 2013 the new Board of Directors conducted a review on economic result for the year 2012 and future perspective of the business. It became clear that actual results were much lower than forecasted in the financial documentation at the basis of the restructuring procedure just completed, and consequently the budget for the year 2013 needed a downside update, at the light of the contraction in advertising expenses of Italian Small and Medium Enterprises. According to the contraction of the 2013 budget, management considered that Seat could not generate a level of cash flows sufficient to ensure the regular payment of principal and interests expiring in 2013, equal to about 200 million Euro. From the financial statements point of view, the budget contraction and deterioration of future perspectives required a relevant impairment of goodwill on balance sheet, which was actually written in 2012 financial statements, determining an enormous loss leading to negative book value of equity. From the legal point of view, according to articles 2446 and 2447 of Italian

Civil Code, the insufficient book value of shareholders' equity required the immediate recapitalization or the opening of the corporate liquidation. To face this complex situation, in January 2013 the Board of Directors stopped the payment of expiring financial expenses, and on 6 February 2013, SPG, jointly with SPG Italia, filed a petition to Turin Court for the obtainment of a period automatic stay (so-called *Concordato con riserva*), aimed at the presentation of a proposal of composition with creditors to the bankruptcy court within 120 days. The petition for the automatic stay blocked eventual enforcement actions by financial creditors and put the business under the supervision of a judicial supervision and a delegated judge. Under the automatic stay, the ordinary conduct of the business was permitted, with the limit to not execute payments of debts originated before the petition date without the consent of the judge. The petition blocked also the legal obligation for shareholders to restore the level of share capital or deliberate the liquidation of the business because of the negative book value of shareholders' equity.

The first proposal for the settlement of the crisis was presented on 28 June 2013, and it was characterized by a mixed solution in cash and equity. Seat proposed the partial deferred payment of financial debts together with the conversion in equity of their unpaid portion; for other non-preferred debts, they were partly repaid with dilations. After the submission of the proposal to Turin bankruptcy court, the Court officially admitted it on 10 July 2013.

According to the report issued by Dott. Ranalli and submitted by Seat to the bankruptcy court, the proposal planned the settlement of distress claim and modification of financial and equity structure according to following conditions:

- Total cash payment of non-financial preferred claims and preferred quota of financial claims, on the limit of liquidation value of pledged assets;
- Cash payment of non-preferred share of financial claims per an amount close to 20 % of their nominal value, according to a payment schedule in eight instalments from 2015 to 2018.
- Assignation to financial creditors of the 88 % of share capital of the corporation resulting from the restructuring, through emission of new ordinary shares.
- For non-preferred non-financial claims, Seat proposed the cash payment of the 60 % of their nominal value, deferred into five annual instalments.

Unfortunately, during the second semester of year 2013, Seat management and involved stakeholders reviewed the business perspectives, expecting a substantial downturn in future volume of operations and generation of cash flows. The outcome of review required the presentation of a new proposal of composition with creditors on 16 December 2013, whose content is described in detail in the following paragraph.

It must be noted that in the same period, the British subsidiaries Thomson and TDL Infomedia, presiding the business unit of UK Directories, exited *de facto* from the control of Seat group because they were subjected to the bankruptcy procedure called “administration” under British law. The main reason of financial distress and insolvency of the British subsidiaries was the underfinancing of the pension fund of TDL Infomedia employee, and the impossibility for the subsidiary to cover the resulting disequilibria.

4.8.1. Content of the definitive proposal

The preliminary step of the proposal of composition was referred on the corporate level and it was characterized by the planned merger by incorporation between the holding company SPG and its operating subsidiary SPG Italia. The merger was aimed at the reduction of general and administrative costs, at the light of the fact that the holding company did not carry on any activity except for management of the controlling right on the operating subsidiary.
From the point of view of the business strategy, Seat proposed the reduction of industrial costs through the merger of the two historical products, Pagine Gialle and Pagine Bianche in a single paper product. Anyway, corporate strategy was based on the refocusing on Italian market as core market, and to strengthen the business segments of web-based advertising and creation of websites, to be developed also through acquisition of smaller firms operating in the same industry. Seat corporate strategy prescribed the dismissal of non-core subsidiaries: on the first semester of 2014, pending the composition procedure, SPG sold its equity stake of the subsidiary Cipi, operating in the market of promotional gadgets. At the same time, Seat acquired the total equity stake of Glamoo, a firm operating in the segment of web couponing and advertising.
With respect to the settlement of liabilities, creditors were grouped in four classes, and in compliance with legal prescriptions, claims towards the holding SPG were kept separate from claims towards the operating subsidiary SPG Italia, although the two legal entities were bound to be merged after the final approval of the composition. The classes were formed as followings:

- Class A, constituted by credits with preference rights, per an amount of 24.9 million Euro referred to SPG Italia and 6.4 million Euro referred to SPG;
- Class B, constituted by credits originating from the lending agreement with The Royal Bank of Scotland, per an amount of 668 million Euro, jointly and severally due by SPG and SPG Italia;
- Class C, constituted by credits towards senior bondholders, per an amount of 858.6 million Euro, jointly and severally due by SPG and SPG Italia;

- Class D, composed by the other non-preferred credits, per an amount of 71.6 million Euro referred to SPG Italia and 13.3 million Euro referred to SPG.

After the formation of classes of claimants, SPG and SPG Italia proposed the definitive settlement of liabilities as following:

- Class A credits to be fully paid in cash with recognition of legal interest within four months from the approval of the composition;
- Class B credits to be split into preferred share of 17.8 million Euro and non-preferred share of 650.2 million Euro. Preferred share was deemed to be fully paid in cash, while about non-preferred share, it was proposed the satisfaction through assignation of shares of the new corporation, according to the following ratios: 596 shares per Euro of SPG liability, equal to the total amount of the principal due, and 3,834 shares per Euro of SPG Italia liability, corresponding to residual part of principal after the cash payment;
- Class C credits to be split into preferred share of 21.5 million Euro and non-preferred share of 837.1 million Euro. Preferred share was deemed to be fully paid in cash, while about non-preferred share, it was proposed the satisfaction through assignation of shares of the new corporation, equal to the total amount of the principal due, and 3,699 shares per Euro of SPG Italia liability, corresponding to residual part of principal after the cash payment;
- Class D credits to be only partly satisfied on cash: the new corporation promised to pay the 5 % of nominal value of SPG liabilities, and the 20 % of nominal value of SPG Italia liabilities.

The classification of liabilities had been done according to the legal provision on composition with creditors: apart from the Class A, grouping all the credits with general preference rights directly originated by the law, financial creditors were included into Classes B and C, while the other credits, mainly composed by trade payables towards suppliers, were grouped into Class D. Because of the financial nature of creditors of Classes B and C, reflecting the higher risk propensity of the claimants, the proposed settlement for these classes is substantially constituted by the total ownership of the distressed firm. By contrary, the non-financial nature of Class D creditors suggested Seat to propose the cash settlement of that category of distressed liabilities. It must be noted that non-preferred quotas of Classes B and C credits and Class D credits held the voting right for the approval of the composition in the specific hearing called by bankruptcy court. The result of that classification of claims is that the majority prescribed by Italian Bankruptcy Law is reached if the distressed firm obtains the positive vote by the majority of the two classes of financial creditors.

With respect to the separate classification of financial liabilities, it was motivated by the presence of collateralization in fixed assets with book value higher than 25,000 Euro only in favour of The Royal Bank of Scotland. Because of the higher collateralization of the senior loan, Class B presents higher ranking in hierarchy of priority rights, which is reflected in the offering of slightly higher number of shares per Euro of non-preferred claims belonging to Class B than the corresponding claims of Class C. This classification of financial debt in two classes, together with the legal provisions on bond loans produced peculiar effects about the approval of the proposal: Class B is formed by a unique creditor with voting right (RBS bank), so the inevitable outcome of Class B voting was the unanimous consent or rejection. Analogously, Class C voting rights are given to each of the three tranches of the shareholder loan (550 million, 200 million and 65 million): each tranche has only one voting right to be expressed through a representative who refers the outcome of the separate meeting where single bondholders express their opinion and they decide according to majority rules. For these reasons, it can be affirmed that the overall outcome of the composition depended only on the decisions taken by senior creditor and senior bondholders.

To quantify the treatment of financial creditors, it is needed to describe the ownership structure and estimate the value of equity capital of Seat after the implementation of the proposal. The ownership structure of the corporation resulting from the merger of the holding and the operating company is defined by adding shares to be issued in execution of the composition with creditors to pre-existing shares. With respect to the estimation of equity capital, it was determined by the financial advisor KPMG Advisory in 200 million Euro, corresponding to a value per share – after the equitization of financial debt – equal to 0.000031 Euro.

The ownership structure of the reorganized business, as resulting from the transaction is resumed in Table 4.9.

Shares	Percentage	Estimate of Value	Owners
16 billion	0.25 %	498,000 Euro	SPG former shareholders
2,898.1 billion	45.10 %	89.8 million Euro	The Royal Bank of Scotland
3,512.5 billion	54.65 %	108.9 million Euro	Senior Secured Bondholders

Table 4.9 – SPG shareholding structure resulting from the equitization of financial claims Source: Slideshow attached to KPMG Advisory opinion, slide 7, found on https://www.italiaonline.it/wp-content/uploads/2014/01/SPG_Relazione_finale.pdf

Pending the procedure of composition with creditors, on 9 May 2014, the Board of Directors of SPG received from D-Mail a proposal for the integration of D-Mail into Seat Group. D-Mail was operating in the segment of publishing and e-commerce of durable goods, and it was facing a situation of financial distress since it had filed the judicial approval of restructuring agreement. The proposal was characterized by the acquisition of Seat by D-Mail through an offer in cash and D-Mail shares to financial creditors.[13] After a careful examination of the proposal, Seat Board of Directors declined the proposal since it was judged to present a high level of riskiness and uncertainty. The features of the proposal were not sufficient to determine the stop of the procedures for the approval of the pending composition with creditors, and the consequent starting of the preparation of a new composition with creditors centred in the integration of both group. Directors highlighted the fact that an eventual procedure of integration between Seat and D-Mail could be valued and eventually pursued upon willing of the new ownership structure after the approval and execution of the pending composition.

4.8.2. Compliance of the proposal with Best Satisfaction Test

As seen in Chapter 2, the continuation of the going concern within the procedure of composition with creditors shall be functional to the best satisfaction of creditors "in comparison with the concretely practicable alternatives", and the proposal of composition shall offer them at least what they would receive in case of bankruptcy liquidation of the business. These points, conditioning the legal regularity of the proposal, had been analysed in the report of judicial supervisor Prof. Enrico Laghi released according to art. 172 of Italian Bankruptcy Code for the voting of creditors and in the report by Dott. Riccardo Ranalli attached to the definitive proposal of composition. Both experts, according to the legal doctrine, define the best solution of Seat crisis not in comparison with the infinite corporate strategies available for the recovery of distressed business, but compared with the other applicable legal instruments: the bankruptcy liquidation and the extraordinary administration.

Answering to a specific request of Turin Bankruptcy Court, Prof. Laghi states at page 149 and followings of its report, that continuation of the going concern under composition with creditors (pursuant art. 186-bis of Bankruptcy Code) is the best solution to ensure preservation of value for the distressed firm. In fact, the applicable alternative of the provisional going concern under bankruptcy "would inevitably damage the preservation of customer relationships [since] the continuation of the provisional going concerns it subject to the valuation of the creditors' committee on a three-months basis". It follows that the provisional going concern damages the business value, impeding the renewal of advertising agreements with customers, who trust "in the business continuation with indefinite time horizon and not within a definite time limit". Also, "the business is founded on the utilization of intangible assets […] bounded to a rapid

[13] https://www.milanofinanza.it/news/seat-d-holding-offre-piu-cash-e-azioni-dmail-in-concambio-201406101538504234

and irreversible loss of value in any scenario characterized by the technical cessation of the going concern". Furthermore, in the second report by Dott. Ranalli (page 145) it is specified that in case the churn rate becomes close to the 30 %, and substitution of clients does not take place because of uncertainty on supplying of advertising services, the economic equilibrium is not reached and provisional going concern damages the creditors.

With respect to the alternative of extraordinary administration, the report states that the latter institute is aimed at realizing the restructuring and the recovery of equilibrium in a distressed firm without considering the interest of creditors; in that framework the safeguard of business continuity is always ensured, and if necessary it is realized at expenses of debt claimholders.

Then, the report by Dott. Ranalli estimates the liquidation value on separate basis of assets owned by the two companies, to compare amount of estimated proceeds from liquidation with the proposed settlement of distressed claims under the composition. Table 4.10 resumes the estimated proceeds from forced liquidation of SPG Italia assets:[14]

Assets	Liquidation Value
Customer Database	0.9 million
Trademarks	14.9 million
Pledged fixed assets	0.9 million
Other fixed assets	0.8 million
Telegate shares	22.7 million
Telegate holding liquidation	1.1 million
Consodata shares	3.0 million
Paper inventory	2 million
Accounts receivables	68.8 million
Liquidity	186.1 million
Effect from continuity	-7 million
Total assets	294.3 million

Table 4.10 – Estimation of proceeds from liquidation of SPG Italia

Source: Attestation of the modified proposal of composition with creditors, page 142, found on https://www.dropbox.com/s/h5seyqc1tx4tih3/Ranalli%20-%20Seconda%20attestazione%20161-186-bis%20SEAT%20PG.pdf?dl=0

At this point, Dott. Ranalli considers that in case of interruption of the going concern, additional non-preferred liabilities, with respect to claims quantified in the proposal of composition with creditors, shall be satisfied by the bankruptcy procedure: reimbursement of advanced payments for services not provided, estimated in 44.2 million Euro, and reduction of real estate leasing

[14] Second Attestation by Dott. Riccardo Ranalli ex article 161 Italian Bankruptcy Code, attached to the modification proposed by Seat on 20 December 2013, page 142.

for corporate offices estimated in 28 million Euro. Analogously, in case of discontinuity, bankruptcy procedure shall satisfy additional preferred liabilities for severance payments of employees and commercial agents, equal to a total amount of 37.2 million Euro, which were not included in the proposal because of the assumption of business continuity.
Proceeds from liquidation of assets, estimated in 294.3 million shall be devoted to the integral payment of procedural expenses and preferred claims, whose sum is equal to 109.4 million. The residual amount of 184.9 million is devoted to the payment of non-preferred creditors on a strictly proportional basis. The ratio between nominal amount of non-preferred claims and sum available for their satisfaction is 11.08 % (184.9 divided by 1,668.2), lower than 20 % rate corresponding to satisfaction proposed to Class D creditors and to the estimate of equity value attributed to financial creditors.
With respect to the holding company SPG, the liquidation value of its assets is equal to 27.7 million Euro, almost entirely constituted by credits for taxes on income. Preferred claims and procedural expenses sum to 6.6 million, almost equal to the value resulting from the proposal of composition. Total non-preferred claims are equal to 1,573 million, of which 1,526 million referred to financial claims according to joint and several liability resulting from the contribution of operating assets and liabilities. The difference between 27.7 million and 6.6 million is devoted to the satisfaction of non-preferred creditors, who receive the 1.35 % of the nominal value of their claims. It results that in this case too, proposed satisfaction under composition is higher than estimated proceeds from bankruptcy liquidation.
Moving to the analysis of collateralization and preference right, it is important to remember that the applicable legislation confer to financial creditors the right to obtain the priority assignation of proceeds from forced liquidation of collaterals issued by SPG and SPG Italia at conclusion of the restructuring in year 2012. To ensure the fairness and the legal compliance of the content of composition proposal, the distressed firm is requested to present the court a report from an independent expert who estimated the net value obtainable from forced sell of the encumbered assets, according to article 160 paragraph 2 of Italian Bankruptcy Code. At this purpose, SPG and SPG Italia appointed Dott. Marcello Pollio, who conducted and reviewed a separate estimation of collaterals with the help of specialists. With respect to the operating firm, encumbered assets were constituted by Pagine Gialle and Pagine Bianche trademarks, equity investments in the subsidiaries Telegate A.G. and Thomson Ltd, and the overall set of fixed assets with book value not lower than 25,000 Euro.
Main trademarks had been valued in a scenario of bankruptcy liquidation with business discontinuity according to "Relief from Royalty Method", implying the computation of present value, discounted at the proper cost of capital, of royalties which are likely to be obtained under

a fair licensing agreement about trademarks under estimation. About the revenues generation by the trademarks, the expert assumed the business discontinuity and the subsequent transfer of the trademarks, which results in a reduction of revenue stream estimated into 30 % in the first year after the transfer and progressive recovery in a seven years' time horizon. Conducting a separate estimation of revenues from paper operations and internet operations, because of different business cycle of the products, then computing the fair percentage of royalty on revenues and discounting the royalties stream at the cost of capital, resulting trademarks value are presented in Table 4.11. To obtain their net liquidation value, cost of maintenance and the costs of competitive procedure for dismissal must be deducted from market value estimated in a discontinuity scenario. Dott. Pollio estimates these costs in the 5 % of market value, leading to a net value of 14.9 million Euro. The overall computation is resumed in Table 4.11.

	Estimated value
Pagine Bianche – Paper	1.8 million
Pagine Bianche – Internet	1.8 million
Pagine Gialle – Paper	1.5 million
Pagine Gialle – Internet	10.6 million
Maintenance and procedural costs	-0.8 million
Net liquidation value	**14.9 million**

Table 4.11 – Estimate of liquidation value of SPG Italia secured assets
Source: Dott. Pollio report, page 62, found on https://www.dropbox.com/s/r1zxvxgetn8sonm/Pollio%20-%20Attestazione%20160%20co%202%20SEAT%20PG.pdf?dl=0

Then, the expert estimates value of Telegate shares directly and indirectly withheld by SPG Italia and pledged in favour of the senior creditors: the operating firm directly owns the 16.24 % of Telegate equity capital, plus another stake of 61.13 % through the wholly-owned subsidiary Telegate Holding Gmbh, incorporated under German law. Remembering that the shares of the subsidiary Telegate A.G. are listed in the Frankfurt stock exchange, Dott. Pollio did not trust the value expressed by the stock market since the majority stake was withheld by SPG Italia and competition for control of Telegate was not admitted; value of the equity stake directly owned by SPG Italia was therefore estimated through Discounted Cash Flows method, multiples determined by equity markets and multiples from recent transaction in similar industries. The expert estimated an Enterprise Value between 58 and 67 million; adding Net Cash to this value, total equity value ranges between 140.3 million and 149.3 million. Dividing the central value of the range, 144.8 million by the number of outstanding shares, 19.1 million, value per share is estimated in 7.58 Euro. The 16.24 % of total equity value is equal to 23.51 million Euro, so the value of directly owned equity stake of Telegate is downside rounded in 23

million Euro.
With respect to the indirectly-owned controlling stake of Telegate, its valuation was not requested since the proposal of composition assumed its dismissal through a competitive auction, whose proceeds would have been wholly and directly assigned to senior financial creditors, according to the existing pledge, in addition to cash and share payments promised from the proposal. In June 2014, one month before the public hearing for the approval of composition by impaired creditors, Seat filed a modification of the proposal in the sense that the whole set of shares owned by Telegate Holding would be distributed to financial creditors in proportion to financial claims, together with cash distribution of dividends the holding was entitled to receive during the composition procedure and precautionary deposited into a blocked bank account.
Moreover, the expert, in the estimation of values of the UK-based subsidiaries Thomson and TDL Infomedia, determined a null economic value of their equity stakes. In fact, as previously mentioned, the UK subsidiaries were liable toward the pension fund of employees of about 26 million Euro, which determined a negative value of equity both on book value and on market value and caused the opening of bankruptcy procedure of administration.
Analogously, in a separate report, released in the interest of the holding company SPG, Dott. Pollio determined a null equity value of its equity investment into the subsidiary SPG Italia pledged in favour of financial creditors. The null value is determined by the relevant disequilibrium between Enterprise Value and outstanding financial liabilities, and the insufficient generation of cash flows by the operating business, situation which is at the basis of the petition for composition with creditors.[15]
Finally, Dott. Pollio provides the estimation of fixed assets with book value not lower than 25,000 Euro, pledged in favour of The Royal Bank of Scotland. The report states that “assets are constituted by informatic devices (telephone and computers) used by the company and containing the databases. Assets presents very high technical obsolescence and before the dismissal they have to be subjected to a careful cleaning of hardware from software and information.” (Page 54) With the help of an external consultant, liquidation value of those assets was estimated by applying to historical cost a devaluation rate determined in relation to cost of dismission, grade of marketability, separability and rapid advance of technologies: the devaluation rate ranged between 75 % and 98 %. Finally, total liquidation value of those devices was estimated into 930,000 Euro.
In conclusion, the report estimated the value of encumbered assets withheld by SPG Italia equal

[15] Report from Dott. Ranalli attached to the First Proposal of Composition of July 2013, page 323-324.

38.5 million Euro, of which 37.6 million Euro are bound to be shared among senior lender and senior bondholders on a *pari passu* basis, while the residual quota of 0.9 million Euro is devoted to the satisfaction of obligations towards The Royal Bank of Scotland.

4.8.3. Approval and execution of the composition

The definitive approval and implementation of the proposal of composition was subjected to several procedural steps: after the preliminary admission by Turin Bankruptcy Court, it required the verification by the judicial supervisor, the obtainment of prescribed majorities in the voting of creditors and finally the definitive approval by the Court. In the meantime, SPG shareholders were called in an extraordinary shareholders' meeting to approve the increase of equity capital through the conversion of financial credits in shares and the resulting shift of control rights to financial creditors. The passage was quite critical because of the absence of direct shareholders' interest in the approval of the operation since after the execution they would be almost integrally diluted. Furthermore, after the filing for composition with creditors, distressed investment funds who had accumulated a relevant stake of Seat equity through the equitization of Lighthouse bond, rightly after the opening of the composition had entirely sold their shares. The consequence was that equity ownership was totally spread among small shareholders, making more and more difficult to obtain the prescribed majorities for the approval of the resolution by shareholders' meeting. To help the approval of the opening of equity capital by shareholders, Seat proposed the issuance of 339 billion equity warrants to be divided for free among shareholders participating to the meeting. The equity warrants would have expired in April 2016 and they granted the possibility to subscribe new shares of the restructured company, corresponding to a comprehensive stake of 5 % of equity capital, at a strike price measured by average market prices of shares in the four months period after the equitization of financial claims. Finally, the operations on equity capital were approved by the shareholders' meeting on 4 March 2014.

Then, the public hearing for approval of the composition by creditors took place on 10 July 2014 and the outcome was largely positive: the proposal was approved with the 99.79 % of favourable votes for the holding SPG and the 99.51 % of favourable votes for the operating company SPG Italia. As a result, the Bankruptcy Court called a public hearing on 26 September 2014 for the definitive approval of the composition and the examination of eventual oppositions by creditors.[16] After the latter hearing, the Court ascertained the absence of oppositions by dissenting creditors and on 3 October 2014 it definitively approved the content of the

[16] https://www.italiaonline.it/wp-content/uploads/2014/08/01082014_COS_ESITO_ADUNANZA_CREDITORI_ITA_def.pdf

composition with creditors, which became legally binding for the business and all its claimholders.[17]

At that point, Seat put in execution the agreed complex transactions aimed at the modification of share capital and ownership structure: the first transaction was the realization of the merger by incorporation of SPG Italia into the holding SPG, which became effective on 24 October 2014.

At that point, the Board of Directors, considering the number of warrants and shares to be issued and the consequent difficulties in trading huge number of security and in price formation, decided, in conformance to the outcome of extraordinary shareholders' meeting of 4 March, to group new and existing shares and new warrants according to the ratio of 1 security per 100 existing or bound to be issued through conversion of impaired financial claims. After the definitive approval by the regulatory authority, Consob, of documentation for listing of new shares in Milan Stock Exchange submitted by Seat, on 22 December 2014 the following operations were simultaneously executed:

- Reduction of share capital to 120.000 Euro without modification of the number of existing shares;
- Increase of share capital to 19.88 million Euro through the issuance of about 6,410 billion shares at unitary price of 0.000031 Euro, to be settled via the contribution of impaired financial claims belonging to Classes B and C in the composition with creditors.
- Immediate grouping of ordinary shares and saving shares according to the ratio 1 to 100
- Issuance of warrants to participants of shareholders' meeting of 4 March 2014 and to withholders of saving shares.

On the same date, SPG executed also all the promised payments to creditors of Classes B and C. Therefore, in that day they impaired financial creditors received the overall considerations resumed in Table 4.12.

	Class B creditors	Class C
Cash – Preferred claim	17.8 million Euro	21.5 million Euro
Cash – Telegate dividends	10.2 million Euro	13.1 million Euro
Total Cash considerations	28 million Euro	34.5 million Euro
Seat PG shares	2,898 million shares	3,512 million shares
Telegate shares	5.1 million shares	6.58 million shares

17 https://economia.ilmessaggero.it/flash_news/seat_pg_nessuna_opposizione_039_udienza_di_omologa_concordato_preventivo-609578.html and https://www.italiaonline.it/wp-content/uploads/2014/10/OMOLOGAZIONE20DEL20CONCORDATO20PREVENTIVO.pdf

Table 4.123 – Considerations received by financial creditors in execution of the Composition Source: Personal elaboration from Press release on 17 December 2004 available on https://www.italiaonline.it/wp-content/uploads/2014/12/17122014PressReleaseCPExecutionITADEF.pdf and Information Memorandum for the listing of new SPG shares

After the execution of the settlement, it was ascertained that former financial creditors, both bondholders and The Royal Bank of Scotland, had transferred their claims to specialized distressed investors, who collectively obtained a controlling stake in equity capital of the restructured firm. In fact, according to financial statements of year 2014, the reference shareholders, in their quality of managers of distressed investment funds, were the followings:

- GoldenTree Asset Management with the 27.16 % of equity stake
- Marc Lasry with the 23.73 % of equity stake.

The completion of the operations on equity capital and the subsequent change of control, together with the cash settlement of claims belonging to the Classes A and D, closed the long phase of restructuring of financial liabilities, except for the financial leasing on the corporate headquarters, and permitted the Board of Directors, together with the new owners, to seek new strategic option for restarting the process of value creation.

4.8.4. Litigations

The procedure of composition with creditors, characterized by the mandatory renegotiation of pending contracts, guaranteed by the possibility of the distressed firm to file for the breach of unfavourable agreement, is very likely to cause litigations with the contractual counterparty, interested in keeping unchanged the contract under execution. This paragraph describes the contentious renegotiation of two relevant executory agreements: the contract for the printing of paper products, and the real estate leasing for the corporate headquarters. Furthermore, the deep analysis on business perspective conducted by the external professionals involved into the procedural aspects of the composition, together with the shift of control in the hands of financial creditors, led to the promotion of a litigation versus Seat directors in charge from the leveraged transaction to the completion of the equitization of Lighthouse bonds.

With respect to the printing contract, in the petition for the admission to the composition procedure, Seat asked the bankruptcy court to declare the termination of the long-term contract regulating the supplying of printing services for paper directories, with the printer Rotosud – Ilte group. According to report of the judicial supervisor Dott. Laghi, the petition was motivated by the alleged technical incapability of the supplier to provide the new publishing product resulting from the merger of both traditional products, by the level of price higher that competitors and by the presence of pending lawsuits for damages. Since both companies were interested in the continuation of the supplying contract, Seat withdrew the petition for judicial resolution and the parties signed an agreement to settle the dispute. Finally, Seat and Rotosud agreed to terminate the former printing contract and to substitute it with a new three-years agreement presenting economic conditions aligned to best offers in the market, together with the payment from Seat to Rotosud of a una-tantum compensation of about 10 million Euro. The transaction was approved by the bankruptcy court on 12 June 2014; and on 16 June 2014 the external expert Dott. Ranalli recognized the positive effect of the settlement on Seat equity value. (Page 56)

The litigation related to the leasing agreement with Leasint refers to the acquisition of Seat corporate offices in Turin: the leasing was classified in Seat financial statements as financial leasing, with recognition of the real estate value in the asset side of the balance sheet and the present value of leasing instalments in the liability side. According to Dott. Ranalli, the anticipated termination of leasing agreements would increase the equity value of the restructured business because of the reduction of financial liabilities. In this case too, after a long negotiation, Seat withdrew the judicial petition and both parties dismissed the litigation reaching a transaction agreement. Through the agreement, which became binding on 31 March 2015, Seat and Leasint terminated in advance five out seven leasing agreements, with the una-tantum payment by Seat to the leasing company of a total sum of 3.2 million Euro as indemnification for the anticipated termination.

With respect to legal suit for damages proposed in the company interest versus Seat directors in charge from year 2003 to year 2012, the ordinary shareholders' meeting of 4 March 2014 approved a resolution for the opening of the litigation. The litigation was based on an investigation conducted by a legal consultant, who alleged the erosion of equity value through non-necessary investments and financial expenses. According to the report written by the legal consultant in the shareholders' meeting interest (for sake of brevity, hereinafter the "Legal Report")[18], former directors were responsible for damages towards Seat with respect to the following transactions:

- Acquisition of the majority stake of SPG by private equity funds in year 2003 and, especially, distribution of the extraordinary dividend in year 2004;
- Acquisition of the German subsidiary Wer Liefert Was in 2007 and its subsequent dismissal after a year, with a loss of 79.5 million Euro;
- Restructuring of financial debt in 2010 through the issuance of Senior Secured Bonds, characterized by high interest rate;
- Resignation of Mr. Luca Majocchi as CEO and the non-competition agreement;

[18] https://www.italiaonline.it/wp-content/uploads/2014/01/Relazione__CdiA_Seat_ex_art_125_ter_TUF_def.pdf

- Restructuring undertaken in 2012 resulting in the equitization of Lighthouse subordinated bonds.

The complex lawsuit was opened in Turin Court, together with the petition from Seat about the adoption of precautionary measures on assets and personal properties in the hand of the counterparties, to augment probability to obtain an actual compensation for damages eventually ascertained by the court.
At the end of year 2014, Seat received a proposal for the settlement of the litigation submitted by a primary legal firm in the interest of former directors. In the document, the counterparties, together with statutory auditors and the private equity firms promoting the acquisition, committed to immediately pay a sum of 30 million Euro in exchange for the withdrawal of judicial initiatives for recognition and indemnification of damages. At the light of the uncertain outcome of the litigation, the long time required for the trial, the complexities in the collection of evidences and in liquidation of eventual indemnifications, Seat directors called the ordinary shareholders' meeting on the 27 January 2015 for the examination of the settlement proposal. In that date, Seat shareholders, as resulting after the execution of composition with creditors, approved the proposal and definitively dismissed the litigation, with the obtainment of the agreed compensation.

4.8.5. Economic performance during the composition

Moving from technical aspects of the composition to economic performance resulting from annual financial statements, Table 4.13 presents relevant financial data of years 2013 and 2014, with 2012 and 2015 for comparison.

	2012 (Comparable)	2013	2014	2015
Revenues	659,0	507.9	412.1	374.9
YoY Growth	-31.5%	-22.9%	-18.9%	-7.91%
Core Revenues	626.7	475.1	389.9	357.1
EBITDA	228.9	89.5	32.6	26.3
Marginality	34.7%	17.6%	7.91%	6.93%
EBIT	(1,756.5)	(234.4)	(25.5)	(26.3)
Profit/Loss	(1,049.6)	(347.8)	1.375,0	(19.1)
Equity	(968.2)	(1,323.4)	174.3	160.9
Liabilities	2,130.0	2,164.0	369.0	326.2
Intangible Assets	416.8	130.3	121.1	111.7

Table 4.134 – Highlights of financials for fiscal years 2012-2015 – Values in million Euro
Source: SPG official financial statements; 2012 values are taken from 2013 financial statement

In details, year 2013 was characterized by the large reduction of the scope of the business, in conformance with the strategic aim, declared into the proposal of composition, to refocus on core business of Italian directories and digital services. In fact, the proposal of composition with creditors made explicit the initiative for dismissal of Telegate and Cipi equity stakes, separately classified in the financial statement as Available for Sale assets. Furthermore, the group TDL Infomedia, controlling the UK Directories business unit, exited from the consolidation area of Seat group because of its situation of insolvency. These phenomena impacted on the comparability of profit and loss statements between 2012 and 2013 and required the reclassification of 2012 financial statements. Reclassified 2012 profit and loss statements in conformance of the change of perimeter presented revenues level of 659 million Euro and EBITDA level of 228 million Euro. Considering these factors, revenues and EBITDA for year 2013 were equal to 508 million Euro and 89 million Euro; presenting dramatic declines of 23 % and 61 % if compared with reclassified 2012 data. The rate of marginality (EBITDA/Revenues) continuously declined over the years: from 40 % in 2010, it passed to 35 % in 2012 and it was equal to only 17.62 % in 2013.

With respect to Italian Directories business unit, revenues declined of 24.2 % and they were equal to 475 million Euro: the reduction interested both traditional products and web products. Impairment tests on intangible assets resulted in the write-off of goodwill, trademarks and Customer Relationships per a total amount of 197 million Euro.

About extraordinary area, Seat estimated and expensed the cost of composition with creditors per an amount of about 40 million Euro. About financial area, since the proposal of composition was not binding yet, in the profit and loss statement financial costs related to senior loan and senior bonds were completely recognized per a total amount of 130 million Euro, although they were bound to be offset by an extraordinary proceed after the definitive approval of the restructuring. Consequently, profit and loss statement closed with a loss of 348 million Euro.

2013 fiscal year, in addition to the events connected to the composition with creditors, was also characterized by the dismissal of Spanish operations in Directory Assistance business unit withheld through the subsidiary Telegate.

Then, financial statement of year 2014 was largely impacted by the effects of the definitive approval of the composition with creditors, with his revolutionary modification on liability structure and ownership structure. With respect to the perimeter of SPG operations, the non-core subsidiary Cipi, operating in the business of promotional gadgets, was definitively dismissed and, in conformance with the modified proposal of composition with creditors, Seat transferred the controlling stake of Telegate to creditors, retaining only the minority share directly withheld, which was reclassified into consolidated financial statement among financial investments. Also, in June 2014, Seat acquired the whole equity capital of Glamoo, operating in the business of promotional couponing, which became part of Italian directories business unit. As the result of the divestments operated in 2013 and 2014, it followed that, apart from the core business unit of Italian directories, accessory businesses at the end of 2014 consisted in the subsidiaries Consodata and Europages, the former operating in the market of business information and the latter in publishing of pan-European directories for specialized B2B users. Total revenues were equal to 412 million Euro, experiencing a reduction of 18.86 % on the previous year; at the same time EBITDA level was equal to 32.6 million Euro, shrinking of 63.5 %, with a marginality on revenues close to 8 %. With respect to financial area of profit and loss statement, it presented the recognition of interest expenses matured until the date of execution of composition with creditors, per an amount of 128 million Euro. Financial expenses were more than compensated by extraordinary proceeds from write-off of distressed claims in conformance of the composition, with a net positive impact of 1,565 million Euro, which determined the total cancellation of financial liabilities. The approval of the composition impacted on net profit, which was therefore equal to 1,375 million Euro. The positive result of profit and loss statement caused the reconstitution of positive shareholders' equity in the balance sheet, which passed from a negative amount of 1,342 million Euro at 31 December 2013 to a positive level of 174 million Euro at the end of year 2014. Finally, Net Financial Position was characterized by the first time for net cash per 71 million Euro, considering that the only financial debt existing at the end of 2014 was referred to the present value of real estate financial leasing under renegotiation.

The core business of Italian Directories presented a total revenues level of 389 million Euro, whose main components were 82 million Euro arising from paper products, with decline of 32 %, and 250 million Euro originated by web marketing services, characterized by a decline of 14 % with respect to the previous year.

4.9. INTEGRATION WITH ITALIAONLINE

Soon after the entry of new reference shareholders, in May 2015, GoldenTree funds and Avenue funds (under the control of Marc Lasry), decided to undertake an investment agreement for the integration between Seat Pagine Gialle and Italiaonline (IOL). The latter company was an Italian enterprise operating in the segment of internet advertising and management of web portals, owning as main brands Libero, Virgilio and SuperEva. The rationale for the acquisition under negotiation was the creation of "the Italian leader in web advertising for big clients and in communication services for Small and Medium Enterprises (websites, directories and local advertising) […] with relevant potential for growth and representing an instrument for development and digitalization" [19]

The investment project was articulated into three phases: Contribution of SPG shares into IOL, Tender Offer promoted by IOL and the final merger of both firms.

The execution of the investment project started with the contribution of the package of SPG shares owned by GoldenTree and Avenue funds into IOL through a reserved increase of equity capital. Therefore, since 9 September 2015, Seat experienced a change in its reference shareholders: the 53.87 % of outstanding shares were owned by IOL. With respect to IOL ownership structure, its former total shareholder Libero Acquisition was diluted to an equity stake of 66.2 %, while Avenue and GoldenTree funds entered in its equity capital with respective stakes of 15.6 % and 18.2 %.

According to the investment agreement, and in compliance with Italian security law regulating changes of control, after the contribution IOL promoted a tender offer on the total number of SPG outstanding shares held by minority shareholders. The tender offer, not aimed at the delisting of the security, was opened to acceptance from 5 October 2015 to 23 October 2015 at the price of 0.0039 Euro per share, equal to their unitary value attributed by the contracting parties for the settlement of the contribution to IOL. At the expiry date, the offer was accepted by about half of the floating securities, producing the increase of IOL ownership stake to 78.58 % of the ordinary shares. Then, the tender offer was re-opened until 6 November 2015, and after its conclusion IOL was the owner of a stake equal to 80.23 % of SPG equity capital. The tender offer, characterized by a potential maximum cash disbursement of 114 million Euro, was financed by the liquidity available in IOL corporate treasury and by the eventual access to a short-term loan negotiated with Banca IMI. Since the availability of the credit line was planned to expiry after the completion of the merger, IOL obtained the right to devote liquidity and cash flows of Seat to the reimbursement of financial debt. According to the result of the tender offer, IOL used the credit line per an amount of 41 million Euro.

The final step of the transaction was the merger of both companies and the integration of respective operations. The legal procedure for the merger was started right after the conclusion of the tender offer and it consisted in the reverse merger of the controlling company IOL into its subsidiary SPG, which changed its name into Italiaonline. The legal tool of the reverse merger allowed the firm resulting from the merger to automatically inherit the rights connected

[19]Press Release published on the corporate website (URL: https://www.italiaonline.it/wp-content/uploads/2015/05/Project-yellow-Press-release-ex-114-TUF-ITA.pdf) on 22 May 2015 - page 2

with the listing of Seat in Milan stock exchange enjoyed by Seat, thus avoiding the need of presenting a formal request to the regulatory authority and the connected documentation. The reverse merger was characterized by the assignation to IOL shareholders of both Seat pre-existing withheld by IOL and new shares *ad hoc* issued by Seat according to the exchange ratio of 1,350 Seat shares each IOL share. Moreover, the extraordinary shareholders' meeting decided that, rightly after the merger, new shares and existing shares would be grouped according to the ratio 1 share each 1,000 shares. The grouping was aimed at permitting the better marketability of the equity instrument in the stock exchange, since before the merger, Seat shares were considered as "penny stock". In fact, the high number of outstanding shares and low market value determined a unitary price lower than a Eurocent, producing difficulties in price formation. After the completion of the merger, which became effective on 20 June 2016, the resulting company, Italiaonline S.p.A. presented the following ownership structure at 30 June 2016.

58.82 %	Libero Acquisition
13.88 %	GoldenTree funds
16.22 %	Avenue funds
11.08 %	Floating equity

Table 4.14 – IOL ownership structure at 30 June 2016
Source: Report on relevant IOL shareholders published on Consob official website

4.9.1. Distribution of extraordinary dividend

At the time of the call of the ordinary shareholders' meeting for the approval of 2016 financial statements, on 6 April 2017 reference shareholders proposed to the ordinary shareholders' meeting the distribution of extraordinary dividend per a total amount of Euro 79,4 million. The proposal contrasted with IOL business plan, which did not predict distribution of dividends to strengthen the financial position and to sustain investments for growth on internal and external line. The avoidance of dividend distribution for year 2016 was confirmed by the Board of Directors in the approval of financial statement and the call of shareholders' meeting.

Following the receipt of the proposal by shareholders, Board of Directors released a report on the legal regularity and the sustainability of the request.[20] The Board of Directors declared that, although the proposed distribution of the dividend would reduce the amount of equity reserves originated from the acquisition of Seat by IOL, the request was complaint with legal and statutory rules on equity capital. With respect to the sustainability of the extraordinary dividend, the Board of Directors performed a critical review of the business plan, to properly consider the

[20] https://www.italiaonline.it/wp-content/uploads/2017/03/CDA-IOL-10.4.2017-Valutazioni-del-CdA-V7_CLEAN_ITA.pdf

impact on financial area of adverse business scenarios. After the examination of the dynamics of the cash flows and the effect of the extraordinary dividend, it resulted that "the Group would hold liquidity, net of month and seasonal swings" and the result would remain valid in case of unpredictable cash outs, generated by extraordinary events of 5 million Euro per year. The negative effect of the distribution is the lack of liquidity to finance eventual acquisition of businesses in compliance with the business plan, but directors and their advisors, judged that the arising need of financial resource would be easily satisfied through recourse to bank debt or increase of equity capital.

At the light of the public interest of the proposal, the regulatory authority asked IOL the disclosure of further information about the impact of the extraordinary distribution. In the answer,[21] directors highlighted that "the group would hold […] a positive Net Financial Position in the time horizon of the plan", therefore the distribution would not affect economic and financial objectives of business plan 2017-2019. Directors specified that "business plan does not include estimates referred to growth by external lines", so "management will value on opportunistic basis eventual options for growth by external lines". Finally, IOL explained that the concession of social security benefits for laid-off workers was subordinated to the realization of investments for business reorganization: in these terms "the distribution does not affect the hypothesis at the basis of the concession of the social security benefits", with specific reference to the investment plan negotiated with Ministry and trade unions.

Moreover, the Board of Statutory Auditors stated that the request, although it present significant dimensions, also in consideration of the recent history, "it does not appear to threaten neither the going concern of the business, nor the perspectives of development, although it exposes the business to financial risks and it requires effort for positive growth of the business and wise cash flow management".

Despite the analogies between this transaction and the extraordinary dividend distributed in year 2004, on the points of the request by shareholders, the vicinity of a change of control, the reduction of equity reserves originated from a recent merger, the most relevant difference is that in 2016 IOL withheld a positive Net Financial Position, and the size of the extraordinary dividend was lower than liquidity available on treasury; instead, the extraordinary dividend of year 2004 requested the assumption of financial debts, modifying the business perspectives of Seat for many years.

Finally, the ordinary shareholders' meeting, called on 27 April 2017, definitively approved the distribution of the extraordinary dividend, which was paid on 10 May 2017.

[21] https://www.italiaonline.it/wp-content/uploads/2017/03/Comunicato-Stampa_Integrazione-info.pdf

4.9.2. Economic performance since acquisition by Italiaonline

Relevant economic and financial data of SPG-IOL are resumed in Table 4.15 and commented in the paragraph.

	2015 (SPG)	2015 (SPG+IOL)	2016	2017
Revenues	374.9	449.6	389.5	336.0
YoY Growth	-7.91%	9.10%	-13.4%	-13.7%
Core Revenues	357.1	431.7	373.0	330.2
EBITDA	26.3	44.1	63.9	67.7
Marginality	6.93%	9.81%	16.2%	19.9%
EBIT	(26.3)	(27.0)	0.7	27.7
Profit/Loss	(19.1)	(16.4)	22.7	26.4
Equity	160.9	344.9	367.3	315.6
Liabilities	326.2	431.0	333.3	291.8
Intangible Assets	111.7	344.1	317.3	306.9

Table 4.155 – Highlights of financials for fiscal years 2015-2017 – Values in million Euro
Source: SPG and IOL official financial statements

Economic performance of SPG, as a stand-alone basis, of year 2015, showed the continuation of reduction in economic determinants. In fact, total consolidated revenues were equal to 375 million Euro, lower than 2014 by 7.9 %, while EBITDA was equal to 26 million Euro, with reduction of 19.4 % with respect to 2014 and corresponding to a marginality rate of about 7 %. Because of reduction in EBITDA level, 2014 presented a negative EBIT although the effect from extraordinary accounts was almost null: financial statement did not present relevant extraordinary impairments while restructuring expenses were practically offset by proceeds received from former directors and private equity funds to settle the lawsuit for alleged damages. Financial area was characterized by a loss originated from the impairment of minority stake on Telegate, equal to 6.6 million Euro, partly compensated by the conclusion of renegotiation of real estate leasing contracts, which determined a positive impact of 5.9 million Euro on profit and loss statement. The bottom line of the statement presented a net loss of 19 million Euro. With respect to cash flow generation, the settlement of controversies towards financial leasing companies and former directors, is the main reason determining further cancellation of financial debt and increase of Net Financial Position from positive levels of 71.4 million at the beginning of the 2015 to its final value of 106.5 million Euro.

Total revenues from the core business unit of Italian Directories were equal to 357 million Euro, and the contraction with respect to the former year was mainly originated by the reduction of Seat customer base. Main products had been reclassified into Digital and Print areas: revenues from Digital products were equal to 221.5 million Euro, presenting an overall decline of 11.5 %. Among Digital area, services related to Digital Directories and creation of Websites continued their contraction, while intermediation for advertising on Google and Facebook platforms presented a very positive performance, with revenues of 53 million and growth rate of 38 % with respect to 2014. Instead, traditional Print products generated a stream of revenues equal to 102 million Euro, experiencing a growth of 12.6 %, whose positive contribution depended by the launch of the innovative Smartbook with the two traditional directories books merged into one volume. Finally, traditional telephone Directory Assistance reduced its revenues by 42 %, certifying the irreversible declining phase of the service.

With respect to the perimeter of Seat operations, year 2015 was characterized by the termination of the business segment of promotional couponing, by opening the liquidation of the subsidiary Glamoo, acquired the previous year at a cost of 4 million Euro.

Moving to year 2016, it must be remembered that the exercise was characterized by the completion of the reverse merger of IOL into SPG, and the change of company name into Italiaonline, influencing the comparability of annual economic and financial results. Therefore, to ensure the comparability of year 2016 performance to 2015 results it is necessary to refer to pro-forma 2015 data elaborated from the hypothetical merger of both companies. Pro-forma profit and loss statement for 2015 presents revenues equal to 449 million Euro and EBITDA equal to 44 million Euro. With respect to pro-forma data, in year 2016 revenues declined by 13.4 % reaching the level of 389 million Euro; at the same time EBITDA was equal to 64 million Euro, growing by 45 % and highlighting the obtainment of a level of marginality on revenues equal to 16.4 %. EBIT was substantially close to parity, being affected by the strategic decision to classify the accessory subsidiary Consodata among Held for Sale assets, which produced the devaluation of its assets of 7.6 million to align their book value with fair value; at the same time financial area was characterized by the devaluation of minority equity stake of Telegate per an amount of 1.5 million Euro, reflecting a permanent reduction of market prices. Finally, profit and loss statement closed with a profit of 22.6 million Euro, mainly originated by the positive effect generated by the recognition of Deferred Tax Assets in the balance sheet.

In year 2016, the business unit referred to the service of Directory Assistance at telephone number 12.54 was sold to a call centres company, as prescribed by Italian Authority for Competition after the examination of the merger of Seat and IOL. Also, the subsidiary Europages was definitively sold to a private equity fund with a loss lower than a million Euro.

At the end of 2016, Net Financial Position presented a positive value of 122 million Euro, to be compared with a pro-forma level of 74 million Euro at the beginning of the year. The increase in net liquidity reflected the anticipated repayment of the credit line obtained for the acquisition

of SPG minority shares, and the perfection of an agreement for the transfer of real estate financial leasing to a third party, to be executed in 2017.
With respect to revenues mix referred to the core business unit, Digital Italia, it generated revenues equal to 373 million Euro, composed by 239 million Euro generated by Digital segment, 102 million Euro generated by traditional Print segment, with both segments experiencing a rate of decline of 10 % with respect to the previous year, and 31.2 million Euro generated by minor products, including Directory Assistance services. The firm implemented actions for efficiency, reducing all type of costs: industrial costs, commercial costs, general costs and labour costs, which allowed the firm to achieve a relevant growth in EBITDA of the business unit with respect to pro-forma data for 2015. The EBIT pertaining to the business unit was positive and equal to 12.3 million Euro.
Among extraordinary events of year 2016, it must be noted the expiration of equity warrants issued in 2014 as incentives for the approval by former shareholders of the equitization of financial debt in conformance to composition with creditors. Equity warrant became exercisable from 9 May 2016 and they definitively expired on 27 July 2016. During that time window, some warrants were exercised by their respective holders at the strike price of 4.50 Euro, resulting in the emission of 13,893 IOL new shares, with cash increase of equity capital and share premium of 62,500 Euro.
Finally, economic performance of year 2017 was characterized by revenues generation equal to 336 million Euro, experiencing a decline of 13.7 % with respect to the previous year. Despite reduction in revenues, actions for increase of efficiency generated the reduction of industrial, commercial and labour costs: as a result, EBITDA of the year was equal to 67.6 million Euro, with a growth rate of 5.8 % and a marginality rate of 20.1 %. Extraordinary revenues and costs were influenced by the positive income related to the dismissal of real estate leasing contracts equal to 2.1 million Euro, which partly compensated costs of reorganization and redefinition of corporate strategy. EBIT was equal to 27.7 million Euro: since financial area and tax area was not relevant, profit and loss statement closed with a positive result of 26.4 million Euro.
Final Net Financial Position was characterized by Net Cash of 73 million Euro, with a decline of 49 million Euro with respect to the beginning of the year, because of the payment of an extraordinary dividend of 80 million Euro requested by controlling shareholders.
The most relevant extraordinary events of the year 2017 are the completion of the transfer of real estate financial leasing on 23 February 2017, and the strategic decision to stop the dismissal procedure of the subsidiary Consodata, with consequent declassification from Held for Sale assets.
In detail, Digital Italia business unit generated revenues of 330 million Euro, in contraction of

11.5 %, of which 228 million Euro arising from Digital products (-5 % on 2016) and 101 million arising from Traditional products (-21 % on 2016). Digital area was characterized by the positive performance of Advertising services for large accounts and Small Medium Enterprises.

CHAPTER 5: COMMENTS ON BUSINESS DYNAMICS, MARKET PERFORMANCE AND RESTRUCTURING INITIATIVES

After the presentation of economic and corporate information on SPG and IOL, as resulting from official financial statements and mandatory reports released for extraordinary operations on corporate and ownership structure, this chapter develops the critical points referred to the dynamics of the business and the situation of financial distress, examining the effectiveness of initiatives undertaken by involved stakeholders to face the difficult situation. It puts its attention in SPG market value of equity, as resulting from market prices prevailing in the Stock Exchange, and opinions released by equity analysts. Then, forecasted economic figures resulting from business plans are compared with actual results taken from financial statements. Opinions from equity analysts have been taken from the official website of Milan Stock Exchange, while official market prices are taken from the database Eikon owned by Thomson Reuters.
Moreover, financial data from official balance sheets and profit and loss statements have been restated according to the methodology suggested by Koller *et al.* (2015), to obtain reliable values of EBITDA, Net Financial Position and Financial Liabilities by neutralizing the impact of non-monetary accounts, especially provisions for bad debts and commercial risks, which in official SPG-IOL financial statements are always included into EBITDA, and to disentangle extraordinary costs, depreciations and impairments from the computation of cash flows. Tables with restated SPG-IOL Profit and Loss statements, Balance Sheets, and Free Cash Flows prospects are reported in Appendices 2/A, 2/B and 2/C.

5.1. DECLINE OF OPERATING AND FINANCIAL FIGURES

As seen in Chapter 4, in the period between 2004 and 2015, main relevant economic and financial variable presented an overall pathway of decline, very slow until year 2007, then more and more pronounced. In fact, the following tables resume the most critical operating, economic and financial variables of SPG, taken from its official and restated financial statements.

Years	ARPU	Clients	Employees	Commercial Agents
2004	N.A.	676,000	5,338	1,920
2005	N.A.	N.A.	6,105	1,838
2006	N.A.	N.A.	6,661	1,614
2007	2,548	550,000	6,652	1,618
2008	2,548	550,000	6,532	1,707
2009	2,319	488,000	6,088	1,597
2010	2,196	486,000	4,810	1,510
2011	2,150	455,000	4,292	1,241
2012	1,930	379,000	3,997	1,158
2013	1,812	321,000	2,029	1,311
2014	1,633	296,000	1,932	1,393
2015	1,841	231,000	1,849	1,188
Change 2008-2004	N.A.	-18.6%	+22.4%	-11.1%
Change 2015-2009	-20.6%	-52.7%	-69.6%	-25.6%
Change 2015-2004	-27.7%	-65.8%	-65.4%	-38.1%

Table 5.16 – Dynamics of SPG operating figures
Source: SPG annual financial statements, section Management Discussion and Analysis, paragraphs Human Resources and Credit Risk; personal computation of variation rates

Table 5.1 shows the dynamics of some key operating variables of SPG-IOL: first and second columns show the decomposition of revenues stream into Number of Clients and Average Revenue per User, taken from information disclosed in the section "Credit Risk" of official financial statements. While SPG declared its intention to increase both Clients and ARPU since the LBO transaction, as resulting from reports released by equity analysts, it is possible to infer that between 2004 and 2007 the firm made an accurate selection of its customer base, retaining the most interesting advertisers and increasing their average expenditure. From year 2009, the obsolescence of the core products determined churn of customers and reduction in ARPU, depressed also by aggressive commercial policies. For sake of completeness, Figure 5.1 shows the historical dynamics of ARPU and number of clients.

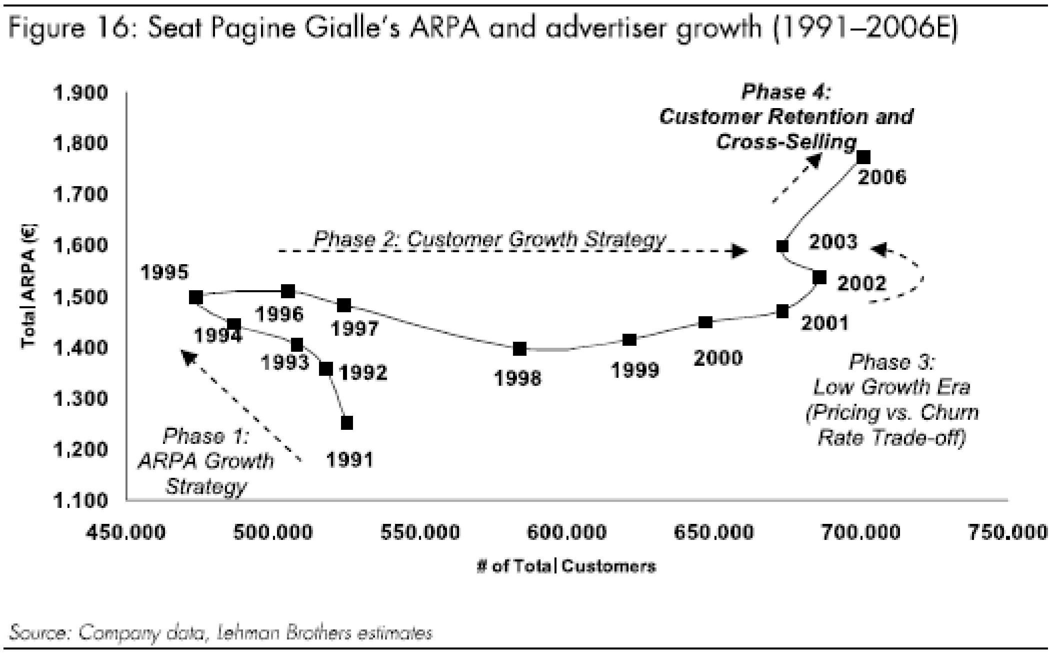

Figure 5.1 – Dynamics of SPG Average Revenues per User
Source: Opinion on SPG share value by Lehman Brothers on 28 January 2004, page 17

The other columns show the dynamics of number of SPG employees and commercial agents: while commercial agents continuously declined over years, number of employees reached a peak in 2007, then it rapidly declined, reflecting the reduction in volumes of operating activity and the need to reduce fixed costs to recover the marginality. It must be noted that reduction of employees has not stopped since 2015: considering the integration of about 400 employees coming from IOL operations, not included in Table 5.1, at the end of year 2017 IOL employees were 1,830, of which 242 were temporarily laid off.

Years	Financial Debt	NFP	Book Equity	EBITDA	Financial Expenses	Market Cap at 12/20
2004	3,952.7	3,843.1	860.0	679.0	253.1	2,619.3
2005	3,741.0	3,567.4	999.7	687.2	272.0	3,295.5
2006	3,613.4	3,334.5	1,075.4	655.5	256.2	3,791.5
2007	3,405.9	3,230.3	1,123.8	697.5	256.7	2,215.1
2008	3,325.3	3,048.1	903.5	655.6	258.8	487.9
2009	3,024.9	2,757.2	1,039.2	585.6	273.5	322.5
2010	2,929.4	2,708.4	228.7	454.9	259.6	166.6
2011	2,881.1	2,727.6	(555.1)	409.2	273.5	53.5
2012	1,530.0	1,343.5	(968.2)	289.0	147.4	74.7
2013	1,658.4	1,472.1	(1,323.4)	131.2	132.9	32.7
2014	39.8	(60.4)	174.3	59.7	130.6	180.7 (*)
2015	49.8	(64.8)	334.9	65.8	4.5	194.5
Change 2008-2004	-15.9%	-20.7%	+5.06%	-3.45%	+2.25%	-81.4%
Change 2012-2008	-54.0%	-56.0%	-207%	-56.0%	-43.0%	-84.7%
Change 2015-2012	-96.8%	-105%	+135%	-77.2%	-97.0%	+160%

Table 5.2 –Dynamics of SPG financial figures – Values in million Euro

Source: Financial figures taken from Appendices 2/A and 2/B, market capitalization measured at 20 December from Thomson Reuters - Eikon database.

(*) 2014 market capitalization refers to 20 January 2015, one month after the equitization of Senior Financial Claims.

Table 5.2 resumes the dynamics of financial variables in the period 2004-2015: Financial Debt and Net Financial Position continuously reduced from 2004 to 2009 of about 200-250 million Euro per year, reflecting the solid cash generation of the business which permitted also anticipate repayments of debt. When cash flow reduced, SPG repaid its debt though emission of new equity in 2009, then with substitution of expiring debt with new debt: it follows that NFP remained constant at the end of years 2009, 2010 and 2011. Then, financial debt was abruptly reduced through equitization of financial claims in 2012 and subsequently in 2014, producing a positive NFP since 2015 which reflected the lower and lower cash generation from restructured operations. The potential cash generation from ordinary activities, under the assumption of immediate cash regulation of operating revenues and costs, is represented by restated EBITDA: it reached its maximum peak in 2007, to deteriorate of 50-100 million Euro per year until 2011, then, in correspondence with restructuring procedures, it declined of 77 % in a three years-time. Financial expenses are strictly connected with debt burden and cash generation: they remained almost constant, in absolute values, on average levels of 250 million

Euro per year until 2008, then the first attempts of restructurings resulted in the increase of financing costs of about 20 million. It must be noted that SPG cash generation declined over years, as previously discussed about EBITDA, so the incidence of remuneration of financial debt on free cash flows became higher and higher. Values from year 2012 are not significant since they were recognized in the accounting books in compliance with accounting principles, but they were not paid because restructuring procedures were pending, and these expenses were finally offset by extraordinary proceeds at the final approval of restructuring measures.

Table 5.2 shows also market capitalization of SPG, which, after the payment of extraordinary dividend in 2004, stabilized to market values close to 2.7 billion Euro. That value rose until year 2007, then it continuously declined, notwithstanding the restructuring measures adopted, determining the total loss of value by original shareholders, shareholders participating in the equity offer in 2009 and converted junior bondholders. At the same time, book value of equity was quite volatile, reflecting negative effects of dividends distribution in years 2006 and 2007, and, mainly, the consequences of progressive impairment of goodwill from 2008 to 2012, previously recognized at the time of the merger of SPG with the vehicles Silver and Spyglass.

Years	Interest Coverage (EBITDA/Fin Exp)	Financial Debt/ EBITDA	Net Financial Position/ EBITDA	Cost of debt
2004	2.68	5.82	5.66	10.97%
2005	2.53	5.44	5.19	7.07%
2006	2.56	5.51	5.09	6.97%
2007	2.72	4.88	4.63	7.31%
2008	2.53	5.07	4.65	7.69%
2009	2.14	5.17	4.71	8.61%
2010	1.75	6.44	5.95	8.72%
2011	1.50	7.04	6.67	9.41%
2012	1.96	5.29	4.65	6.68%
2013	0.99	12.64	11.22	8.34%
2014	0.46	0.67	(1.01)	15.38%
2015	14.62	0.76	(0.98)	10.04%
Change 2008-2004	-5.57%	-12.9%	-17.9%	-30.0%
Change 2012-2008	-22.6%	+4.38%	Constant	-13.1%
Change 2015-2012	+646%	-85.7%	-121%	+50.3%

Table 5.3 – Dynamics of SPG financial ratios
Source: Personal computations from values presented in Table 5.2. Cost of debt is the ratio between financial expenses and the average between financial debt at the end of current year and previous year.

Table 5.3 shows the dynamics of main financial ratios, to support comments to figures presented in Table 5.2. It results that since 2009, interest coverage, rapidly declined from previously values higher than 2.5, reflecting the rise in interest expenses and the continual reduction of EBITDA from operating activities. This situation led to the default of SPG in 2011, since it omitted the payment of interest coupon on Lighthouse bonds, and to the need, in the first months of 2013, to ask the protection of composition with creditors. The incidence of debt over EBITDA reduced by 13 %, moving from the initial value of 5.8x to 4.88x in 2008, then the ratio rose to unsustainable levels because EBITDA shrank, and financial debt was impossible to be definitively repaid, so the unique solution was its total cancellation completed at the end of 2014. About cost of debt, it varied between 7 % and 7.7 % until 2008, reflecting the dynamics of interest rates, then it jumped to values higher than 8.6 % as the result of renegotiation of senior loan with The Royal Bank of Scotland and the emission of Senior Secured Bonds at unfavourable conditions. Reduction of cost of debt of year 2012 is determined by the equitization of junior bonds; then, values of years 2014-2015 are not significant because SPG residual debt was very low and Net Financial Position was positive.

5.2. BUSINESS PLAN VS ACTUAL RESULTS

At the end of year 2003, Seat disclosed to financial community the decision to merge the vehicles and to distribute the special dividend, together with the new business strategy ensuring the sustainability of the relevant financial burden. Equity analyst unanimously agreed on the opinion that proposed extraordinary transactions are fair for minorities, and they put their attention on the amount of dividend and the assumption of debt. With respect to the industrial plan, the report issued by Lehman Brothers on 28 January 2004 disclosed that generation of revenues from advertising is based on both increasing in the number of customers, from attraction of new advertisers, and in the increasing of Average Revenues per customer from upselling and cross-selling initiatives. Moreover, SPG planned to reduce the credit risk on trade receivables by accurate control of recovery of expired receivables, and selection of reliable clients through request of automatic bank payments. Many equity analysts, for example Merrill Lynch in its report issued on 30 November 2004, states that the strategy to increase both ARPA and volume was not realistic, since there is a trade-off between the dimensions: growth of customer base requires discounted prices which generally reduce Average Revenues, as it occurred in SPG from 1996 to 2002. Furthermore, there were limited room to increase prices, since SPG risked the loss in quantity of advertisements. In fact, as previously commented, SPG commercial strategy resulted in accurate selection of advertisers' base, aimed at the reduction of small and unreliable clients, together with retention of medium-high customers and upselling policies.

SPG business plan provided the forecasted financial results in a 10 years-time horizon resulting from the implementation of the business strategy, and the connected forecasted cash flows to ensure the proper satisfaction of financial obligations. From the Legal Report about the litigation between SPG and Directors, already described in Chapter 4, it results that on 15 October 2003, the Board of Directors approved the following EBITDA forecasts for the period 2004-2011, elaborated with the consultancy of the investment bank Lehman Brothers.

2003 Business Plan	2004	2005	2006	2007	2008	2009	2010	2011
EBITDA base	663	741	800	852	888	925	960	998
Growth rate	10.1%	11.8%	7.96%	6.5%	4.23%	4.17%	3.78%	3.96%
EBITDA conservative	654.2	705.2	737.2	759.8	782.6	806.1	830.3	855.2
Growth rate	8.61%	7.8%	4.54%	3.07%	3 %	3 %	3 %	3 %

Table 5.4 – EBITDA forecasts in 2003 SPG Business Plan
EBITDA values in million Euro – Source: Legal Report, page 2, personal computation of growth rates.

Then, on 26 March 2004, SPG Board of Directors approved a more conservative set of financial forecasts, with EBITDA values resumed in Table 5.5, with the specification that in the baseline scenario complete satisfaction of financial debt is ensured, while “in the conservative scenario regular payment of principal and interest is ensured until year 2010. From 2011, the reimbursement of residual debt requires a refinancing of overall Euro 1,780 million” (Page 3)

2004 Business Plan	2004	2005	2006	2007	2008	2009	2010	2011
EBITDA base	630	685.4	750.3	796.2	833.5	870.9	905.9	942.6
Growth rate	4.59%	8.79%	9.47%	6.12%	4.68%	4.49%	4.02%	4.05%
EBITDA conservative	605	636	665	694	721	751	778	805
Growth rate	0.44%	5.12%	4.56%	4.36%	3.89%	4.16%	3.6%	3.47%

Table 5.5 – EBITDA forecasts in 2004 SPG Business Plan
EBITDA values in million Euro – Source: Legal Report, page 3, personal computation of Growth rates.

Despite the content of these industrial plans, actual EBITDA for the period, as resulting from the annual financial statements, were much lower than the most conservative plan, reaching levels and growth rates resumed in Table 5.6.

Year	2004	2005	2006	2007	2008	2009	2010	2011
EBITDA actual	614.4	626.6	611.4	648.1	602.7	527.6	416.5	370.6
Growth rate	2.00%	1.98%	-2.42%	6.00%	-7.01%	-12.4%	-21.1%	-11 %
Actual/Conservative	101.5%	98.5%	91.9%	93.4%	83.5%	70.2%	53.5%	46%

Table 5.6 – SPG actual EBITDA levels
EBITDA values in million Euro – Source: official SPG financial statements, personal computation of rates: Conservative refers to EBITDA values in Table 5.5.

From the comparison of forecasts with actual EBITDA levels, it results that, also in the positive period (from 2004 to 2007), growth of operating margin was very limited, then in the period of crisis, it started to dramatically reduce with a double-digit rate of year-on-year decline. The deviation between actual results and conservative scenario formulated in year 2004 was very small for years 2004 and 2005, then it becomes wider over years, since the effect of missed targets cumulated over years, as showed by the ratio computed in the last row of Table 5.6, and as resulting in Figure 5.2. Remembering that, according to the Legal Report, the verification of results planned in the conservative plan would have required the renegotiation of financial debt in 2011, it follows that such lower results would determine earlier unsustainability of debt, as it occurred from the end of year 2008.

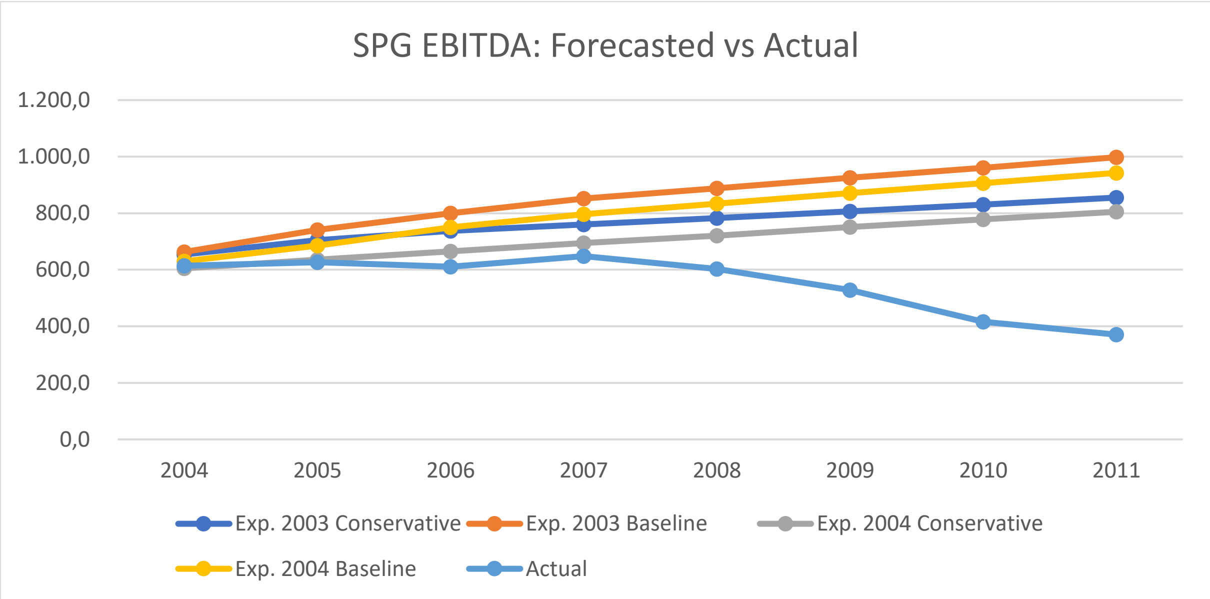

Figure 5.2 – Comparison between forecasted and actual SPG EBITDA values
Personal elaboration from EBITDA values presented in Tables 5.4, 5.5 and 5.6

From the market point of view, the fact that operating targets were systematically not reached, resulted lower and lower trust on SPG budgets pointed out by equity analysts, who declared that the core market was more than mature, while the segment of online advertising was characterised by uncertain perspectives, since at that time access to Internet was still limited and Italian Small and Medium Enterprises were characterized by low digital alphabetization. In this context, they positively judged the decision by Private Equity funds to exit from the target firm in 2007 via strategic or financial options, as a possibility to change control and re-boost the core business though new strategies. Moreover, in 2009, they expressed positive opinion about the resignation of the CEO Luca Majocchi, hoping the change in top managerial line would finally produce the radical shift of business conduct.

Concluding this section, despite low guidance on budget and forecast, discussed in the previous paragraph, until the first semester of 2008, cash generation was solid, and it permitted the distribution of dividends in 2006 and 2007, for a total amount of 100 million Euro (referred to the profits of fiscal years 2006 and 2007), and the growth by external lines in the segment of Directory Assistance. In fact, in 2007 SPG expanded its Directory Assistance operation in Turkey through a joint venture and it acquired from a competitor the German subsidiary Wer Liefert Was. Those acquisition determined a total cash outflow of 133 million Euro. Also, in the first semester of 2008, Telegate acquired the German firm Telegate Media, with a cash disbursement of 33 million Euro, as resulting from the financial statement for year 2008. While Telegate Media was definitively integrated into Telegate, the Turkish joint venture and Wer Liefert Was did not bring positive contribution to SPG consolidated figures: as explained in Chapter 4, the German business was sold at the end of 2008, with a financial loss of 75.5 million Euro.

From an *ex-post* perspective, at the light of unsustainability of financial debt and low overall contribution from acquired firms on consolidated results, it would had been better to devote the cash disbursement of ordinary dividends and acquisitions, to the reimbursement of financial debt or to investments in core business of directories and development of digital services for Italian target customers.

5.3. MARKET PERFORMANCE BETWEEN 2003 AND 2005

Moving to the discussion of the impact on SPG equity market performance of operating and financial events, in year 2003 Private Equity investors interested in the acquisition disclosed their strategy to create value through financial leverage, in the moment the demerger between SPG and Telecom Italia Media was announced to the market. For that reason, when new SPG shares were separately listed, their performance in the Stock Exchange was very positive because extraordinary dividends, or equivalent distributions to minority shareholders, were expected, and the information was immediately incorporated in the price. In fact, since the execution of the spin-off on 4 August 2003, SPG shares traded at a unitary price higher than 0.80 Euro, with a market capitalization higher than 6,500 million Euro, to be compared with the unitary price negotiated between Telecom Italia and PE Investors of 0.598 Euro, corresponding to an overall equity value of 4,852 million Euro. About the rise in market price, the report issued by Deutsche Bank suggested investors to do not tender shares to the vehicle Silver: the suggestion was followed by investors, who did not tender their shares to Silver. With respect to the impact of expected Seat recapitalization, the analyst Caboto estimated a positive contribution of debt recapitalization on equity value equal to 0.10 Euro per share, since the asset value was estimated in about 0.7 Euro per share and the estimated target price at 18 August 2003 was equal to 0.81 Euro per share. Moreover, Caboto stated that financial debt was sustainable until a level corresponding to 4x EBITDA for year 2003. On this point, the analyst Euromobiliare, in its 18 August 2003 report, stated that planned financial debt of 3.8 billion Euro is quite stretched, at the light of the difficulties in achieving further increases of efficiency: Seat "has already undergone a stringent efficiency improvement process after privatization and also under Telecom Italia management […] EBITDA grew from € 250 mln to over € 620 mlm and EBITDA margin almost doubled from 28% to 53%" (page 3)

By the way, from the spin-off to the end of year 2003, SPG market price ranged from 0.79 to 0.88 Euro and, excluding Merrill Lynch who suggested investors to sell SPG shares, equity analysts were quite optimistic on SPG shares, estimating a target price close to market value or even higher. The expectations were focus on the implementation of the new strategy and on the execution of the recapitalization of the firm.

In year 2004, after the distribution of extraordinary dividend, the stock value presented a reduction higher than the amount of dividend, since SPG price per share moved from 0.83 Euro on 15 April 2004, to 0.34 Euro on 12 May 2004, with a reduction of 0.49 Euro while the dividend paid was equal to 0.43 Euro per share. In the month of May 2004, equity analysts, were quite cautious, estimating a target price ranging from 0.35 to 0.45 Euro, slightly higher than actual prices. Only Euromobiliare and Banca Akros suggested to Accumulate the stock, based on the alleged solidity of the underlying operating business, while Deutsche Bank, Lehman Brother, Ras Bank and UBS expressed a Neutral rating. These equity analysts pointed out the maturity of paper directories business, which determined disappointing results for the first semester of 2004, and the need of waiting until the second semester of 2005 to appreciate positive effects from new business plan. According to report released by Euromobiliare on 6 October 2004, low results of year 2004 depended on weakness of advertising market and aggressive commercial policies in large cities, presenting high discount and low control of clients' reliability in payment of receivables, therefore market expected the announcements the business plan would have been downsized at the end of 2004. The equity analysts Merrill Lynch, Lehman Brothers, UBS and Banca Akros reached the same conclusions.

After the disclosure of updated business plan, on 30 November 2004 Mediobanca stated that reference market had radically changed, determining the need to modify approach toward clients and to ensure their retention. Therefore, revenues growth rates were expected to be 2% for 2005 and from 5% to 6% for years 2006-2007, while EBITDA was expected to be close to

666 million for year 2006. The analyst pointed out that second half of year 2004 was characterized by reduction of revenues in big cities, because of lower advertising expenses from big accounts, and careful selection of reliable clients, only partially offset by positive contribution of lower bad debt provisions; the trend was expected to continue also for year 2005.

With respect to market performance, in the second half of 2004 overall capitalization fluctuated toward average value of 2,600 million Euro, with a minimum close to 2,200 million Euro in the month of October, followed by upper rebound: the corresponding price per share moved from 0.33 Euro to a minimum of 0.26 Euro. Equity analysts' opinions for the same period were generally cautious, with prevalence of Hold or Neutral rating and overall target prices ranging from 0.29 Euro to 0.45 Euro for the most optimistic opinions.

As expected, revenues for 2005 were quite stable, since many equity analysts labelled that year as another transition year and they were worried about reduction of revenues from directories in big cities and threat of competition on directories by Cairo Communication group, which, for sake of information, never launched its publishing product. Despite weaker top line than expected, cash generation was judged as solid, and it permitted high debt reduction and growth for external lines through acquisition of Cipi and foreign businesses on Directories Assistance segment. Equity analysts pointed out that acquired firms were very small, if compared with the volume of SPG core revenues, and they were not able to drive high growth rates resulting from business plan, but they could only ensure the stability of revenues stream. In fact, revenues from Italian directories were suffering reduction of advertising expenses, especially in big cities, and reduction of customer base resulting from the commercial policy of focusing toward bigger and reliable customers. Also, the acquisition of foreign businesses did not allow the achievement of synergies with the core business, resulting in limited scope for increasing growth or efficiency of operations. From the point of view of shareholders, the adoption of IAS-IFRS principles, with subsequent necessity to impair goodwill and intangible assets only in case of durable loss, permitted SPG to close the accounting profit and loss statement with a positive result and to eventually distribute dividends, with a cap equal to 3 % of market capitalization deriving from financial covenants agreed with the senior lender.

During year 2005, market performance was characterized by growth in capitalization from 2,639 million Euro at 20 January 2005 to 3,295 million Euro at 20 December 2005, corresponding to prices per share ranging from 0.31 Euro to 0.40 Euro.

5.4. CONSIDERATIONS ON RESTRUCTURING ATTEMPTS

In the Legal Report, SPG consultants expressed high scepticism about the restructuring attempts undertaken in 2010 and in 2011-2012, pointing out that in January 2010 the investment bank hired by SPG manifested the need of a further equity injection of 800 million Euro, but the lack of interest by controlling Private Equity funds would have triggered the breach of financial covenants. Therefore, the investment bank suggested the issuing of Senior Secured Bonds "to face immediate financial needs, knowing that the bond issuance would not have solved the problem to face repayment of financings due on 2012" (Legal Report, page 12). Definitively, Senior Secured Bonds, were considered, also by financial advisor, to be a solution only in the short-term horizon, which would had determined a sharp rise in cost of debt, negatively affecting financial statements and availability of cash for investments, as already seen in the first part of this chapter.

In legal consultants' opinion, SPG was in a situation of deep crisis since year 2009, which was externally manifested through the sharp reduction of EBITDA for year 2009 with respect to 2008. Moreover, the strategic decision to shift the core business from paper publishing to Internet advertising, would have generated the obligation for Board of Directories, in compliance with applicable accounting principles, to deliberate the almost total impairment of goodwill value, and the subsequent adoption of radical measures to face the erosion of shareholders' equity from the first months of 2010.

Instead, the Legal Report states that decision to adopt extraordinary intervention was taken on 21 June 2011, when, with the support of an investment bank, the Board of Directors proposed the equitization of Lighthouse bonds, and it expressly excluded the recourse to composition with creditors. In legal consultants' opinion, SPG was in a situation of insolvency since October 2011, when directors suspended the payment of interest coupon on Lighthouse bonds, although the out-of-court restructuring was not approved yet. According to documentation supporting the Lighthouse equitization, sustainability of senior debt after the equitization of Lighthouse bonds assumed EBITDA levels equal to 343 million Euro in 2012 and 342 million Euro in 2013, while actual EBITDA resulting from profit and loss statement for year 2012 was only 296 million Euro, including an extraordinary income of 56 million Euro deriving from the conclusion of a litigation involving the German subsidiary Telegate.

The situation is quite suspicious, since the peculiar business cycle of SPG permitted a good level of visibility of revenues and reliable estimation on one-year time horizon. In fact, collection of orders for advertising products from clients started 18 or 12 months before the release of directory book or generation of the web advertisements, which triggered the recognition of revenue in SPG profit and loss statement. On this point, the Legal Report states:

"the examination of orders book allows to determine, with sufficient reliability, revenues in the subsequent 18 months. So, in July 2012, directors were able to estimate amount of revenues and magnitude of full 2012 EBITDA, and to value the perspectives until December 2013" (page 17).

It follows that, despite the predictability of revenues and EBITDA for years 2012 and 2013, SPG Board of Directors pursued the transformation into equity of Lighthouse junior bond, being involved in complex legal and procedural steps in United Kingdom, Luxembourg and Italy, which required six months for the completion. It must be stated that the decision was likely to be influenced by the sudden death of the CEO Alberto Cappellini in the month of April 2012, which left SPG without a strategic leadership until the end of October. Therefore, reasonably the Board of Directors inertially implemented the agreed out-of-court restructuring in conformity of approvals obtained by shareholders and debt holders, without considering alternative resolutions who had required another long phase of negotiation with stakeholders. In fact, on 4 September 2012, the Board of Directors declared that, from the comparison of interim financial statement at 30 June and the business plan, there were no relevant deviations compromising the reasonableness of the certified plan ad its capability to ensure debt restructuring and resolution of financial disequilibria. (Legal Report, page 18)

Finally, it is important to observe that out-of-court restructuring was completed in September 2012, and shareholders' meeting appointed the new Board of Directors on 22 October 2012. After three months from the entry in charge of the Board, SPG entered in default, since on 31 January 2013 it did not pay interests on senior debts and it was forced to file for composition with creditors. On these decisions, the Board of Directors explained that "in the preparation of 2013 economic and financial budget, […] cash generation from operating activities, despite positive and high, together with actually available liquidity, would not have been sufficient to face financial commitments expiring in 2013, equal to about 200 million Euro of interest payments and principal reimbursement". (SPG 2012 financial statement, page 9)

5.4.1. Restructuring costs

From the joint examination of financial statements from year 2011 to 2014, together with information taken by the above-mentioned report by legal consultants, it results that total extraordinary direct costs sustained by SPG for out-of-court restructuring of years 2011-2012 were equal to 86 million Euro. Because of the *ex-post* insufficiency of the out-of-court restructuring in resolving SPG financial troubles, legal consultants proposed to qualify direct restructuring costs as a damage suffered by the firm and therefore to include that sum in the litigation for damages versus directors in charge at the time.

Total direct expenses for that restructuring procedure included 27 million Euro referred to professional fees sustained in the interest of Private Equity investors and creditors' committees, and 26 million Euro paid to bond holders as consent fees to favour the reaching of the requested number of positive votes for the official approval of restructuring term sheet. From this information, professional and procedural costs directly referred to corporate and financial reorganization were equal to about 33 million Euro, resulting in the conversion into equity of financial liabilities equal to 1,235 million Euro.
The payment of consent fees and professional fees for senior creditors had been criticized by Dott. Ranalli in the report aimed at certifying the feasibility of the composition with creditors, because they were not referred to the interests of SPG and Lighthouse, but only to the interests of financial creditors. Therefore, he suggests also that the total amount consent fees and professional fees referred to senior creditors (equal to 10.6 million Euro) were theoretical susceptible to clawback actions in case of bankruptcy liquidation. (Dott. Ranalli first report, pages 370-371)
So, total costs of SPG-Lighthouse restructuring appear to be high if compared with total direct costs of the subsequent composition with creditors undertaken in years 2014-2015. Surprisingly, total direct costs of composition procedures may be estimated in 34.3 million Euro, almost corresponding to net reorganization costs in the former attempt. In fact, SPG financial statements for year 2013, included an estimate of these costs equal to 40 million Euro, of which 33 million classified among provision and 6 million in professional and judicial fees. Then, in 2014 financial statement, professional and judicial expenses were equal to 8.3 million Euro, while provisions estimated in 2013 were written-off for a total amount of 14 million Euro. We remember that the composition with creditors resulted in the net cancellation of financial and non-financial liabilities for a nominal value of 1,546.2 million Euro, including the positive effect related to the termination of financial leasing agreements.

5.4.2. Simulation on goodwill

According to a simulation conducted on SPG financial statement, which assumes the inapplicability of International Accounting Standards to SPG financial statements, and the need to systematically amortize assumed goodwill on a 20 years' time horizon, it results that profit and loss statements, and subsequent decision about dividends distribution in 2006 and 2007, were heavily biased by the accounting treatment of goodwill. In fact, according to figures presented in the next page, under these assumptions SPG profit and loss statements for years between 2005 and 2009 would continuously result in a relevant loss. To increase reliability of the simulation, the effects of paid dividends and extraordinary impairments of goodwill have been neutralized. Then, book value of shareholders' equity has been progressively reperformed keeping as starting point the equity for year 2004, officially computed from Italian accounting principles, and considering the cumulated effect of adjusted loss. Variations in equity capital resulting from official balance sheets have been computed and added in the table, expressly excluding equity injection of year 2009.

The result is that, first, the systematic presence of loss would had determined the impossibility to distribute the above-mentioned ordinary dividends. Moreover, the cumulated effect of losses would had rapidly eroded equity reserves existing in year 2004, which would had turned to a negative amount in year 2008. So, from year 2008, cumulated losses would have impacted the value of Share Capital. In 2009, the cumulated loss would have determined a reduction of Share Capital higher than 33 %, determining the need to take radical interventions for preservation of share capital or the liquidation of the firm, as prescribed by Italian Civil Code.

Years	2003	2004	2005	2006	2007	2008	2009
Official Controlling Profit (Loss)	**16.406**	**79.930**	**131.905**	**80.136**	**98.399**	**(179.646)**	**(38.041)**
Adjustments:							
Annual impairment of Goodwill		*(180.142)*	*(180.142)*	*(180.142)*	*(180.142)*	*(180.142)*	*(180.142)*
Neuralization of IAS/IFRS Impairments						*130.793*	*91.297*
Adjusted Controlling Profit (Loss)		(100.212)	(48.237)	(100.006)	(81.743)	(228.995)	(126.886)
SYNTHETIC BALANCE SHEET							
Goodwill	3.602.834	3.422.692	3.204.737	3.033.835	2.858.434	2.786.359	2.443.941
Investment (Disposals) in Goodwill		(37.814)	9.240	4.741	108.066	(162.276)	6.735
Other Assets	2.224.875	1.828.009	1.742.785	1.648.487	1.418.595	1.410.755	1.260.320
Neutralization of Dividends Paid			*0*	*42.121*	*100.599*	*100.803*	*(98.389)*
TOTAL ASSETS	**5.827.709**	**5.212.887**	**4.956.762**	**4.729.184**	**4.485.694**	**4.135.641**	**3.612.607**
Equity Reserves 2004		*522.699*	*522.699*	*522.699*	*522.699*	*522.699*	*522.699*
Equity Reserves 2003	*4.154.087*						
Cumulated changes in Equity				*(1.956)*	*37.096*	*39.997*	*(3.526)*
Other change in Equity			*(1.956)*	*39.052*	*2.901*	*(43.523)*	*(20.177)*
Cumulated Profit (Losses)			*(100.212)*	*(148.448)*	*(248.454)*	*(330.197)*	*(559.192)*
Adjusted Profit (Loss)	*(32.454)*	*(100.212)*	*(48.237)*	*(100.006)*	*(81.743)*	*(228.995)*	*(126.886)*
Adjusted Equity Reserves	4.121.633	422.487	372.295	311.341	232.499	(40.019)	(187.081)
Original Share Capital	247.539	247.539	247.539	247.539	247.539	247.539	247.539
Adjusted Controlling Equity (AER+OSC)	**4.369.172**	**670.026**	**619.834**	**558.880**	**480.038**	**207.521**	**60.458**
Equity Non-controlling Interests	**5.351**	**9.788**	**19.617**	**18.246**	**23.824**	**26.946**	**21.911**
Liabilities	**1.453.186**	**4.533.073**	**4.317.311**	**4.152.058**	**3.981.832**	**3.901.174**	**3.530.238**
EQUITY+LIABILITIES	**5.827.709**	**5.212.887**	**4.956.762**	**4.729.184**	**4.485.694**	**4.135.641**	**3.612.607**

Table 5.77 – Simulation of impact of systematic amortization of Goodwill

Values in thousand Euro - Personal elaboration of data from SPG Balance Sheets and Profit and Loss Statements, according to the previous paragraph.

5.5. COMMENTS ON COMMERCIAL POLICY AND NEW STRATEGY

Moreover, reports from Dott. Ranalli and Dott. Laghi point out that in 2010 SPG carried on aggressive commercial policies, by proposing agreements for bundles of paper and internet advertising services on a two years' period. In this way, the business attempted to sustain the top-line through higher volumes of services provided and to reduce the churn rate of clients, but, on the other hand, the company was reducing its marginality, selling more services (directories and internet advertising) at lower discounted prices with respect to previous years. A consequence of the new focalization of SPG strategy on internet advertising and the prevalence of revenues from digital services with respect to paper directories was the modification, occurred in June 2011, of accounting policies for recognition of revenues in the profit and loss statement. In fact, the firm moved from the recognition of total price of the service in the moment the advertisement was released and published, fitting for paper advertising, to a *pro-rata temporis* criterion for progressive recognition of revenues, reflecting the necessity to perform continuous operating activities to keep digital advertisements available to final users. (2011 SPG financial statement, page 25)

During years 2011 and 2012, in the attempt to sustain orders flow and to reduce the declining pathway of revenues, SPG contacted clients to push the renewal of advertising agreements before their natural expiration. Whether the renewal was accepted, SPG immediately recognized in its profit and loss statement the overall amount of revenues not provided yet in conformance to the former advertising agreement, clearly altering the *pro-rata temporis* principle. That policy produced an artificial shift of revenues, naturally referred to future fiscal years, toward the current fiscal year, naturally producing an immediate improvement of performance, naturally offset by lower level of revenues in the subsequent year and the need to adopt aggressive commercial strategies to sustain retention of customers and collection of new orders. These accounting policies created difficulties for external stakeholders in the comprehension of the actual dynamic of revenues, in the attempt of deferring the crisis recognition and the adoption of radical measures consistent with the severity of decline. (2012 SPG financial statement, page 32)

From a careful reading of financial statements from years 2010 to 2015, it is curious to observe that, despite the announced change of strategic focus from paper and internet directories to on-line advertising services and creation of websites for Small and Medium Enterprises, SPG continued to segment its business units in Directories and Other Activities, continuing to use a label that reflected the historical business of SPG. Moreover, until fiscal year 2014 (included), in the Managements' report (attached to official financial statement), revenues from the "Directories" business unit were split according to the traditional classification of Paper, Internet and Voice services. In the report for fiscal year 2015, SPG changed the structure of segment reporting, highlighting revenues from Digital services and splitting them in the products lines of Directory, Web Agency and Reselling. For year 2015, inside Digital services, with revenues equal to 221,5 million Euro, the component from Directory products was predominant in its area, having generated revenues equal to 117 million Euro, corresponding to about the 53 % of the top line of Digital area.

These facts may signal some inconsistencies between planned strategy and realized strategy: although SPG, in official presentations, labelled itself as a "Local Internet Company", and it opened 74 local subsidiaries to control the commercialization and production of digital advertising services, called Digital Local Services companies, it continued to generate most of revenues from advertising on printed and digital telephone directories. Other digital services, such as reselling of marketing instruments on search engines and creation of website for Small and Medium Enterprises continued to present low incidence on total revenues until the integration into IOL.

Finally, after the transformation of SPG into IOL, 2016 financial statement presented a different reporting structure: the core business unit changed its name into "Digital Italia", split into three segments: Digital, Print and Others. Moreover, in the financial statement for year 2017, segments were only two, labelled as Digital and Traditional: the former segment was constituted by all digital advertising services, while the latter segment included revenues from print directories, directory assistance services and minor non-digital marketing services. These recent classifications of revenues and services are more consistent with IOL strategic focus on generation and supplying of digital marketing service for Italian businesses.

5.6. MARKET PERFORMANCE DURING DECLINE AND RESTRUCTURING

Moving to the opinions of equity analysts released to the public, they were available for the period between year 2008 to 2010, despite the continual reduction of number of banks covering the security and decline in number of reports issued.

The first step of debt restructuring, undertaken in year 2009 and constituted by the renegotiation of Senior loan with The Royal Bank of Scotland and the connected increase in share capital, was carefully followed by some equity analysts who, generally, issued a negative opinion.

In fact, in its report released on 5 December 2008, Citigroup declared that the equity injection of 200 million Euro requested by the senior creditor "appears too little, even though it accounts for 40 % of current market cap […] also retail investors own a big chunk of capital and are sitting on significant losses". Moreover, SPG shares are risky since they are penny stocks, and a change in price equal to half a Eurocent produces a 6 % variation on price, which is heavily affected by speculative actions. On 29 December 2008, Citigroup writes "the agreement doesn't solve the real big issue. We estimate Seat doesn't generate enough cash to reimburse its debt under the current schedule. So, we believe a full (and expensive) debt restructuring must take place". On the same report, Citigroup pointed out that 2009 estimates of EBITDA were reduced to 560 million from 600 million, in any case lower than EBITDA generated in year 2002, with expectation to return in 2011 at level of 2008. Moreover, on 27 January 2009, Citigroup states "we would agree with BC Partners' Investment strategy of not subscribing". Finally, on 20 February 2009, Citigroup seems to predict the future extraordinary events of Seat, highlighting the decline of print products and the low attractiveness of internet products for the customer basis, and stating: "we think Seat will eventually be forced to swap debt into equity, with the junior bonds being the obvious candidate".

Also, the analyst report by Kepler released on 7 January 2009 points out that the capital increase simply delays SPG financial problems: "neither the renegotiation of covenants nor the share capital increase, in our view, are sufficient to support the turnaround of Seat PG", suggesting reducing the position on SPG stocks. On 9 March 2009, Citigroup, in confirming the suggestion to sell the shares, highlights BC Partners funds were the main shareholder of SPG, and its decision to not taking part to the equity injection is quite worrying.

On the opposite site, Deutsche Bank, in its reports issued from 5 November 2008 to 9 February 2005, rates SPG shares as Buy, proposing a target price equal to 0.15 Euro per share; after the completion of equity injection, it moved to a neutral rating "Hold" with a target price of 0.23 Euro, kept constant until the end of year 2009.

After the execution of equity injection, on 26 June 2009 Kepler issued a dramatic report on SPG shares, reducing the target price to 0.01 Euro (from current price of 0.17 Euro), stating that decline in print advertising was faster than expected and growth in the online side was very slow. Kepler judged the increase in capital as a simple option to delay debt restructuring in 2011, and the definitive solutions for SPG financial imbalances were an increase of capital in minimum 1 billion Euro or the equitization of senior debt. Moreover, in the opinion released on 5 August 2009, Citigroup stated: "We still see senior debt repayments as very challenging, and we fear that Seat might eventually be forced to swap debt into equity". Finally, on 19 November 2009, Kepler determined a null value per share: print directories were dramatically declining, and the connected low generation of EBITDA would inevitably produce the breach of covenants and the entry in a situation of default.

With respect to SPG market capitalization, during year 2008 it reduced from the initial value of 1,885 million Euro at 18 January 2008, to 487.9 million Euro at 19 December 2008, presenting a reduction in value of about 75 %. Then, in year 2009, SPG market capitalization continued to

reduce until 164.78 million Euro at 20 March, then after the conclusion of equity injection, its market value reached a maximum of 505.9 million at 18 September 2009, the it gradually reduced to 322 million Euro in December.
In year 2010, following the sharp reduction in market capitalization for SPG, interest of equity analysts in the security declined and reports from investment banks became rare. In fact, in that year, only 10 reports were issued, of which 6 had been produced by the same analyst: Deutsche Bank. That analyst continued to suggest a neutral approach toward the stock, estimating a target prices equal to 0.18 Euro in the first half of 2010, then cut to the level of 0.15 Euro in the second half. Goldman Sachs, which released its reports on 16 March 2010 and 10 November 2010, although it set respective target prices of 0.17 and 0.14 Euro, very close to current market prices, rated the security as Sell, negatively considering the weakness of core business operations, reflected in the continual decline of revenues and EBITDA. Finally, the report issued by Kepler on 25 November 2010, while confirming the null equity value estimated in November 2009, denounced that SPG was returned a penny stock – as it had already occurred in the end of 2008 – and the burden of 2.7 billion Euro of debt was clearly unsustainable. Kepler suggested the adoption of extraordinary measures composed by both cash equity injection and conversion of financial debt, predicting that a debt level of 1.3 billion Euro would be sustainable under the condition of EBITDA ranging between 450 and 480 million Euro.
Market value in year 2010 presented such a reduction that SPG value returned to the situation preceding the equity injection, causing the loss of the overall sum contributed by investors. In fact, at 20 December 2010, SPG capitalization was equal to 167 million Euro.
Then, in the period between 2011 and 2016, no report from equity analysts were issued, because of low capitalization of the title and situation of trouble and uncertainty which drove away investors' interest; coverage by analysts restarted only in 2017, after the transformation of SPG into IOL and return to positive economic performance.
The unique equity analysis released between years 2011 and 2016 was issued by Kepler on 14 March 2012, when involved stakeholders consented on the equitization of junior debt. The analyst pointed out that the reduction of EBITDA to levels close to 350 million Euro, and expected to further shrink, threatened the sustainability of residual 1.5 billion Euro of debt, which would have needed a renegotiation in 2016: "if the group is not able to stabilise its EBITDA, in a couple of years it may fall again in a pre-default situation". According to Kepler, who however expressed a negative rating for the security reflecting the dilution of original shareholders, equity value after conversion was finally estimated by the analyst in about 1 billion Euro, keeping a negative rating for current shareholders' point of view.
In details, during years 2011 and 2012, SPG equity value continued to dramatically decline,

reaching a minimum level of 47.1 million Euro at 20 January 2012, finally ranging from 55 to 65 million Euro right before the equitization of Lighthouse bonds. At that time, Lighthouse bonds traded in the bond market at a price corresponding to the 12 % of nominal value from May 2012 to August 2012, so the junior bond loan market price was close to 156 million Euro. The execution of the equitization increased SPG market value of shares to 153 million Euro at 20 September 2012, but the persisting of the situation of distress rapidly driven its value to a range between 70 and 90 million Euro until January 2012.

The petition for composition with creditors caused another huge decline in market capitalization, which ranged between 25 and 35 million Euro during the whole judicial procedure. Finally, according to the content of composition with creditors, pre-existing shareholders bore the almost total loss of share value, since after the equitization of senior financial debt, SPG market capitalization reached an amount of about 190 million Euro, slightly lower than value estimated by SPG financial advisors. Form the point of view of market value, after the execution of composition with creditors, SPG shares were characterized by a positive performance: in year 2015 rumours for acquisition by IOL shifted market capitalization to 296 million Euro on 20 May, then value stabilized to 250 million Euro at the time of IOL tender offer.

In the time window between the conclusion of IOL tender offer on SPG shares (November 2015) and the subsequent merger of both firms (June 2016), SPG market capitalization declined to values ranging from 155 to 195 million, then the merger boosted IOL value to about 260 million Euro, which remained almost constant for the second half of year 2016. Finally, in 2017, following positive economic and financial performance, together with the requested distribution of extraordinary dividends, produced positive effects on IOL market capitalization, which shifted from 257.66 million Euro at 20 January 2017 to 363 million Euro at 20 April 2017, then it persisted on values above the threshold of 300 million Euro for the remaining part of the year, even reaching a maximum capitalization of 394 million Euro on 20 September 2017.

CONCLUSIONS

In modern economies characterized by openness of real and capital markets at worldwide level, together with disruptive innovation in technology and exposure to global competition, many industries are nowadays exposed to risk of obsolescence and decline of their products and services. It follows that, during their overall lifecycle, firms shall continuously adopt strategic measures aimed at the conservation of competitive advantage, they shall invest in innovation, then redeploy distinctive resources and competences in the offer of valuable products and services to target customers. These measures permit a business to hold over time the control of its key resources (tangible or, more frequently, intangible and human) and to defer the entry in situations of decline and crisis.

When a situation of decline and crisis occurs, the survival of business activities is jeopardized by lack of financial resources and by sudden deterioration of relationships with key stakeholders. It follows that, as explained in Chapter 1, top management shall put high effort in the recognition of the causes of crisis and to start as soon as possible the turnaround process, characterized by the removal of identified inefficiencies and by the restart of value creation through operating activities. The critical point is about the implementation of required extraordinary measures: the action plan shall be shared and approved by stakeholders who inevitably bear a sacrifice in their personal interest to advantage the business' sustainability. Therefore, relationships between distressed business and its stakeholders are negatively affected by opportunistic behaviours such as the holdout problem, informational asymmetry and lack of reciprocal trust, which are likely to defer the adoption of extraordinary measures, thus limiting their effectiveness. To ensure higher success of negotiations and turnaround plans, avoiding further deterioration in value and improper cessation of still valuable businesses, advanced economies provide legal and institutional frameworks, known as bankruptcy law, which favour the timely adoption of efficient measures to recover residual positive value of distressed businesses and to ensure the best exploitation of key resources.

Moving to Seat Pagine Gialle case, the firm was acquired in 2003 by a consortium of Private Equity investors through a Leveraged Buy-Out, on the (wrong) assumption that the underlying core business of directory publishing would have remained stable for a long-time horizon, and whose growth was likely to be boosted with incremental innovation on products and limited Capital Expenditure for growth. The general stability of revenues stream and marginality between year 2004 to 2007, followed by a rapid decline and obsolescence of the core products from 2008, rapidly determined the unsustainability of financial debt and the need to undertake a long restructuring process.

As suggested by Gilson *et al.* (1990), attempts to restructure assets and liabilities, whether conducted out-of-court, are intensively affected by holdout problems which are likely to negatively affect the negotiations, resulting in limited interventions, which are insufficient to solve structural problems of the business. In these cases, distressed firms shall start new negotiations with stakeholders to define more incisive measures, hoping to finally obtain their consent and to effectively exit from the situation of decline and crisis. This situation occurred in Seat Pagine Gialle: the distressed firm was involved into four restructuring attempts from 2009 to 2015, characterized by progressive higher intensity of interventions, which finally resulted in the total write-off of exposure towards financial lenders. The overall restructuring ensured the business continuity and its valorisation through business combinations. In fact, residual resources were integrated into Italiaonline, to finally create a point of reference in the business of Internet advertising for Small and Medium Enterprises, achieving the strategic goal that SPG stand-alone did not reach because of lack of internal competencies and scarcity of financial resources for relevant investment in new web-based products and services.
In first and second restructuring attempts, SPG focused on renegotiation of outstanding financial liabilities, by undertaking private negotiations with its main senior lender, who released his consent on initiatives which protected its position: these attempts resulted in rise of interest rate for residual debt and anticipated reimbursement of about 800 million Euro, raised through a small stake in new equity capital (issued through a very-high dilution ratio for pre-existing shareholders since the market did not show interest in the offer) and a new bond loan with high interest rate, expiring in seven years.
Despite the partial rescheduling of financial debt, SPG was still in trouble, so it undertook a long and complex negotiation with shareholders and overall financial claimants, resulting in the conversion of SPG junior debt into equity, which determined the shift of control in the hands of junior bond holders. Since the assumptions on sustainability of residual debt were not realistic, at the light of irreversible decline of the directory business and overall weakness of advertising market, four months after the completion of that restructuring, new SPG Board of Directors was forced to file a petition for composition with creditors in the bankruptcy court: only the latter procedure allowed the total cancellation of financial debt and the availability of residual assets to be valorised through M&A transactions.
To value the opportunity of managerial choices and pathway followed for SPG reorganization, it is not sufficient to look at the facts, but it is necessary to pay attention on reasonableness of the choices at the light of information available at the time of the decision, on an *ex-ante* perspective. From the examination of critical points developed in Chapter 5, it is possible to conclude that the original LBO transaction was motivated by solid cash generation, and it

obtained a large consensus by equity analysts, who generally agreed on stability of revenues and EBITDA over years. On the other hand, the presence of high financial debt, reduced the amount of cash available for operating investments in launch of complementary products and acquisitions.

The insufficiency of financial resources had become evident since the end of 2008, when SPG faced a general decline of advertising expenditure and of paper directories by declaring the shift of its core business to the supplying of digital advertising services for Small and Medium Enterprises. The success of new strategy would had required relevant investments in software and human resources for creation and commercialization of valuable digital products able to satisfy the needs of target customers, while SPG was focused on creation of standard websites and reselling of marketing services from Google. Therefore, from 2009 to 2015, despite the announced change in core business, the firm was still focused on the declining segment of directories advertising, and it tried to boost revenues through aggressive commercial policies.

With respect to the restructuring attempts undertaken from 2009 to 2012, with special reference to Lighthouse equitization, their low effectiveness was probably determined by strong contractual position of senior creditors, who had pushed the determination of a SPG Enterprise Value higher than their claims' nominal value through unrealistic assumptions, resulting from the holdout problem. This situation was consistent with the empirical analysis conducted by Gilson (1997), who found that out-of-court restructurings, although they constitute the first attempt of managers to sort out situations of financial crisis, on average, they result in limited reduction of outstanding debt: it follows that residual debt burden remains unsustainable and it determines the need of further restructurings. Moreover, SPG financial structure, composed by junior bonds, three tranches of senior bonds, a senior loan, and financial leasing, did not fit for out-of-out restructurings, because of high incidence of holdout problem and low external pressure for approval. In fact, in SPG case, the deadlock situation was manifested through long negotiations for discussion of the solution and the need of payment of relevant *consent fees* to favour the obtainment of the minimum share of approvals.

Moreover, in out-of-court restructuring, senior creditors obtained higher collateralization of claims, higher interest rate without cancellation of principal, as counterparties for postponement of maturity date of the senior loan. The agreement was also constituted by complex, and almost useless from an operating point of view, transactions on corporate structure, such as the contribution of the whole firm to SPG Italia at the expenses of the overall business, in the only interest of junior and senior creditors. At the light of this result and the complexity of 2011-2012 restructuring, it is possible to state that immediate recourse to a judicial instrument for crisis resolution would have been likely to facilitate big reduction of debt (including senior debt) to facilitate the recovery of the distressed firm. This solution had probably reduced the extra procedural costs determined by low level of commitment and consent on needed measures. The threats of cram-down and business liquidation in case a sufficient consent lacked, would have been likely to favour the cooperation of involved creditors in reaching an advantageous agreement for all involved parties with lower cost and higher timeliness.

In fact, applying the approach suggested by Moyer (2012) to the outcome of SPG reorganization, it is reasonably possible to conclude that, since 2011, SPG residual Enterprise Value was sufficient to only ensure a partial recovery of senior financial claims, so the "fulcrum security" was in the hand of senior creditors, while junior bond holders had irreversibly lost their investment. At the light of aggressive commercial policies, decline of market and reduction in EBITDA, it seems not reasonable that the huge loss of Enterprise Value, formally recognized in 2012 financial statement, had not manifested earlier. So, at that time, it was critical to take radical interventions, including total impairment of junior claimants, in conformance to their contractual position, and to rapidly shift the controlling stake of equity to senior creditors. Whether new shareholders had taken timely and consistent implementation of a new strategy, through new investments or M&A transaction, SPG operations would had restarted the value creation from a more favourable position. In addition, the presence of external supervision of neutral experts and mandatory rules in the judicial procedure, would have helped higher disclosure of information among involved stakeholders, facilitating the acknowledgement of the real situation of crisis by all involved parties. It must be remembered that additional positive effects, from SPG point of view, of composition with creditors in years 2013-2014 were the renegotiation of financial leasing and printing agreements.

On the other hand, the recourse to composition with creditors had inevitably caused negative return for SPG external image and reduction of business activities. As explained by Gilson (2012), judicial procedures reduce trust by external stakeholders on the firms' capability to honour its agreements, especially by clients who expect the service they have paid for is performed on a continual basis, and this effect is more pronounced when the business is based on intangible resources, since these firms and their key resources suffer direct losses from bad news. It follows that, potentially, the reduction in SPG customer base experienced in years 2013 and 2014 was influenced by the negative image determined by the entry into composition with creditors, but it must be remembered that directories business was in irreversible decline and it had been damaged by aggressive commercial policies which reduced the product value. So, reasonably, the earlier entry of SPG into composition with creditors would not had determined further negative effects on revenues.

In conclusion, as exemplified by the case study, the choice between judicial and non-judicial

procedures for resolution of financial distress is not straightforward, and it is not true that out-of-court restructurings are always better than judicial procedures since the latter are long, costly and they damage the corporate image, as the common sense suggests. By contrary, after a deep and sincere recognition of reasons behind the situation of decline and crisis, incumbent shareholders and management are asked to select the instrument that best fits for the actual situation. It means that the ideal pathway of restructuring should minimize incidence of opportunistic behaviours and unnecessary costs, while it should ensure the return of financial burden to sustainable levels, together with a timely recovery of valuable resources inside the business. Models presented in Chapter 2 may help the proper selection of pathway for negotiation with stakeholders and subsequent reorganization, according to specific features of the business, environmental factors and the position of involved external stakeholders.
The case study shows also the potentiality of reformed composition with creditors regulated by Italian law, in conformance to the U. S. experience of Chapter 11: over years, the Italian tool has been changing its nature from a framework for liquidation of distressed business and satisfaction of creditors, to an institute aimed at helping the reorganization of businesses possessing residual value in continuity and at restarting the process of sustainable value creation. Composition with creditors is also aimed at reduction of opportunistic behaviours by stakeholders, who are, by contrary, incentivized to actively participate in the reorganization and to directly enjoy the result of their choices. The hope is that, as suggested by Giacosa and Mazzoleni (2012), financial creditors and involved stakeholders, rather than stopping relationships with businesses who enter in composition with creditors, causing the need for forced liquidation of still valuable businesses, recognize the positive potentialities of these innovations: in this way they would permit the safeguard of good parts of distressed business and the creation of new value which benefits the overall economic system.

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APPENDICES

APPENDIX 1/A: DATA FROM OFFICIAL SPG-IOL PROFIT AND LOSS STATEMENTS

YEARS	2003	2004	2005	2006	2007	2008	2009	2010
TOTAL REVENUES	1,451,631	1,410,100	1,430,580	1,468,779	1,449,588	1,374,971	1,214,475	1,039,214
Cost of raw materials	(552,882)	(73,057)	(68,211)	(64,862)	(61,417)	(56,308)	(45,408)	(37,423)
Cost of services		(445,039)	(450,785)	(508,417)	(442,724)	(415,331)	(360,758)	(343,660)
Cost of labour	(223,545)	(209,216)	(219,128)	(231,921)	(242,615)	(236,663)	(218,176)	(199,490)
Loss on receivables	(41,652)	(37,965)	(40,771)	(37,441)	(38,741)	(44,509)	(48,745)	(35,722)
Provisions	(31,216)	(26,688)	(19,888)	(9,739)	(11,211)	(13,972)	(9,257)	(2,666)
Other operating costs	0	(3,753)	(5,237)	(4,975)	(4,756)	(5,493)	(4,530)	(3,757)
EBITDA	602,336	614,382	626,560	611,424	648,124	602,695	527,601	416,496
Depreciations and impairments	(272,151)	(199,044)	(194,458)	(195,336)	(203,884)	(343,020)	(252,160)	(750,637)
Extraordinary income/expenses	(42,987)	(31,321)	(11,144)	(12,932)	(9,017)	(17,587)	(15,740)	(9,187)
Restructuring expenses		(4,645)	(764)	(1,038)	(7,519)	(13,741)	(13,973)	(31,517)
OPERATING RESULT	287,198	379,372	420,194	402,118	427,704	228,347	245,728	(374,845)
Financial income	12,384	8,978	24,185	11,374	18,727	33,612	26,423	16,568
Interest expenses	(139,118)	(259,937)	(284,753)	(257,583)	(258,505)	(281,819)	(241,306)	(270,527)
Gains/losses from Securities	1,593	6,576	4,243	(5)	(3,314)	(5)	36	35
Gains from Composition		0	0	0	0	0	0	0
EARNINGS BEFORE TAXES AND AFS	162,057	134,989	163,869	155,904	184,612	(19,865)	30,881	(628,769)
Taxes on income	(117,256)	(48,930)	(25,383)	(74,116)	(79,482)	(69,190)	(54,173)	(87,938)
Income from AfS assets	(27,202)	0	175	0	1,108	(84,625)	(12,337)	(240)
NET INCOME	17,599	86,059	138,661	81,788	106,238	(173,680)	(35,629)	(716,947)

YEARS	2011	2012	2013	2014	2015	2016	2017
TOTAL REVENUES	961,792	659,008	507,931	412,133	449,554	393,507	340,490
Cost of raw materials	(29,634)	(275,671)	(22,419)	(15,670)	(271,934)	(13,939)	(2,321)
Cost of services	(336,946)		(244,745)	(238,050)		(192,130)	(180,222)
Cost of labour	(181,607)	(91,789)	(105,922)	(95,292)	(109,748)	(99,782)	(77,599)
Loss on receivables	(25,768)	(51,113)	(41,501)	(25,093)	(19,699)	(14,894)	(7,570)
Provisions	(12,751)	(8,974)	(231)	(1,933)	(1,931)	(5,422)	(2,434)
Other operating costs	(4,449)	(2,579)	(3,622)	(3,467)	(2,117)	(3,393)	(2,683)
EBITDA	370,637	228,882	89,491	32,628	44,125	63,947	67,661
Depreciations and impairments	(761,253)	(1,884,582)	(277,896)	(49,921)	(54,164)	(54,104)	(35,909)
Extraordinary income/expenses	(29,809)	(100,834)	(43,078)	(7,242)	(16,933)	(9,356)	(1,930)
Restructuring expenses	(12,594)		(2,973)	(1,001)		252	(2,061)
OPERATING RESULT	(433,019)	(1,756,534)	(234,456)	(25,536)	(26,972)	739	27,761
Financial income	16,041	675,155	2,659	2,221	1,860	2,555	1,320
Interest expenses	(284,428)	(147,353)	(132,910)	(130,573)	(4,459)	(2,486)	(639)
Gains/losses from Securities	(378)	0	0	(2,648)	(6,618)	(1,499)	0
Gains from Composition	0	0	0	1,565,052	5,887	0	0
EARNINGS BEFORE TAXES AND AFS	(701,784)	(1,228,732)	(364,707)	1,408,516	(30,302)	(691)	28442
Taxes on income	(87,184)	174,884	13,174	(15,069)	13,660	23,341	(2,025)
Income from AfS assets	0	4,294	3,733	(18,428)	222	0	0
NET INCOME	(788,968)	(1,049,554)	(347,800)	1,375,019	(16,420)	22,650	26,417

APPENDIX 1/B: DATA FROM OFFICIAL SPG-IOL BALANCE SHEETS

YEARS	2003	2004	2005	2006	2007	2008	2009	2010
FIXED ASSETS	4,714,126	4,460,937	4,353,158	4,165,916	4,113,640	3,735,650	3,570,086	2,895,441
Indefinite-lived Intangible Assets	3,602,834	3,565,020	3,574,260	3,579,001	3,687,067	3,393,998	3,309,436	2,637,197
Definite-lived intangible assets	954,658	777,654	624,703	485,871	347,873	219,752	119,169	91,240
Tangible Assets	42,579	35,697	49,648	50,013	55,709	43,716	37,207	32,217
Financial leasing	0	0	0	0	489	62,886	60,173	56,445
Equity investments	8,327	209	254	288	5,707	2,372	343	378
Financial Assets - loans to employees	3,720	4,917	1,330	1,592	2,126	2,140	2,203	2,284
Deferred tax assets	100,340	76,027	101,837	48,346	14,343	10,442	40,562	74,934
Other non-current assets	1,668	1,413	1,126	805	326	344	993	746
CURRENT ASSETS	1,113,583	932,092	963,887	1,061,572	992,022	1,068,189	999,341	946,283
Inventory	12,890	10,313	12,444	11,891	15,703	15,211	10,482	10,399
Trade Receivables	754,713	684,297	669,740	668,681	671,101	671,014	621,601	613,088
Tax credits	69,242	16,306	6,267	5,239	21,054	7,016	8,376	4,300
Other Credits	96,154	81,352	70,891	66,243	66,532	68,414	64,973	75,270
Financial current assets	14,653	1,947	2,387	1,323	13,083	1,932	1,918	1,498
Liquidity	165,931	137,877	202,158	308,195	204,549	304,602	291,991	241,728
Assets available for sale	0	0	0	0	0	914	329	0
TOTAL ASSETS	5,827,709	5,393,029	5,317,045	5,227,488	5,105,662	4,804,753	4,569,756	3,841,724

YEARS	2003	2004	2005	2006	2007	2008	2009	2010
GROUP EQUITY	4,369,172	850,168	980,117	1,057,184	1,100,006	876,595	1,017,352	213,590
Share capital	247,539	247,539	248,012	249,879	250,352	250,352	450,266	450,266
Share premium reserve	4,154,087	541,845	441,893	460,428	465,103	465,103	466,843	466,843
Legal reserve								
Other reserves	0	(19,146)	158,307	266,741	286,152	340,786	138,284	14,628
Result for the period	(32,454)	79,930	131,905	80,136	98,399	(179,646)	(38,041)	(718,147)
MINORITIES EQUITY	5,351	9,788	19,617	18,246	23,824	26,946	21,911	15,064
Share capital and reserves	4,462	3,659	12,861	16,594	15,985	20,980	18,478	13,517
Result for the period	889	6,129	6,756	1,652	7,839	5,966	3,433	1,547
SHAREHOLDERS' EQUITY	4,374,523	859,956	999,734	1,075,430	1,123,830	903,541	1,039,263	228,654
NON-CURRENT LIABILITIES	159,186	3,835,455	3,604,317	3,462,771	3,265,331	3,111,017	2,482,763	2,685,937
Financial liabilities	105,170	2,513,070	2,273,792	2,125,640	1,926,171	1,766,442	1,125,960	1,327,196
Subordinated liabilities	0	1,247,431	1,252,897	1,258,549	1,264,201	1,269,470	1,270,052	1,276,023
Severance payments fund	32,427	52,916	52,781	56,768	47,183	34,767	42,896	38,641
Deferred tax liabilities	1,497	10	2,059	0	5,089	14,168	14,028	7,498
Other liabilities	20,092	22,028	22,788	21,814	22,687	26,170	29,827	36,579
CURRENT LIABILITIES	1,294,000	697,618	712,994	689,287	716,501	790,157	1,047,475	926,883
Financial liabilities	555,602	172,927	196,926	211,835	198,133	272,036	611,474	308,789
Subordinated liabilities	0	19,306	17,375	17,375	17,375	17,375	17,375	17,375
Trade payables	273,333	274,257	292,754	292,919	276,814	256,993	228,947	207,593
Provisions	74,027	60,890	50,366	39,259	44,165	52,460	49,928	45,637
Tax liabilities	243,730	43,057	40,958	23,533	54,413	72,764	39,258	50,653
Deposits and deferred income	147,308	127,181	114,615	104,366	125,601	118,529	100,493	296,836
Liabilities connected to AfS		0	0	0	0	38	255	250
TOTAL EQUITY AND LIABILITIES	5,827,709	5,393,029	5,317,045	5,227,488	5,105,662	4,804,753	4,569,756	3,841,724

YEARS	2011	2012	2013	2014	2015	2016	2017
FIXED ASSETS	2,129,400	508,610	177,958	173,172	375,487	355,271	345,912
Indefinite-lived Intangible Assets	1,940,373	91,068	0	0	250,720	250,720	250,720
Definite-lived intangible assets	78,591	325,707	130,338	121,115	93,360	66,605	56,193
Tangible Assets	31,725	29,641	12,744	9,978	11,752	8,654	9,430
Financial leasing	52,821	38,124	27,303	24,777	6,628	0	0
Equity investments	0	0	0	10,254	3,646	2,111	2,699
Financial Assets - loans to employees	2,414	2,037	1,015	869	2,358	3,469	2,901
Deferred tax assets	22,800	16,503	696	462	191	152	117
Other non-current assets	676	5,530	5,862	5,717	6,832	23,560	23,852
CURRENT ASSETS	796,741	653,298	493,580	370,112	397,906	333,564	261,522
Inventory	10,409	9,862	4,458	3,927	3,789	2,210	1,279
Trade Receivables	520,797	360,528	229,815	182,830	197,070	161,786	137,794
Tax credits	27,237	23,758	21,786	27,567	26,598	7,215	10,194
Other Credits	62,080	57,104	39,056	44,615	46,098	40,177	37,113
Financial current assets	3,486	2,387	2,039	2,718	785	610	666
Liquidity	172,732	199,659	196,426	108,455	123,566	121,566	74,476
Assets available for sale	602	0	169,015	0	2,525	11,801	0
TOTAL ASSETS	2,926,743	1,161,908	840,553	543,284	775,918	700,636	607,434

YEARS	2011	2012	2013	2014	2015	2016	2017
GROUP EQUITY	(568,759)	(996,460)	(1,342,907)	174,429	295,472	367,337	315,593
Share capital	450,266	450,266	450,266	20,000	7,558	20,000	20,000
Share premium reserve	466,847	466,847	466,847	117,155	207,628	117,217	117,217
Legal reserve				4,000	884	4,000	4,000
Other reserves	(696,122)	(870,852)	(1,912,417)	(1,345,893)	75,350	203,470	147,959
Result for the period	(789,750)	(1,042,721)	(347,603)	1,379,167	4,052	22,650	26,417
MINORITIES EQUITY	13,681	28,309	19,479	(92)	49,453	0	0
Share capital and reserves	12,899	25,532	19,676	4,056	50,860	0	0
Result for the period	782	2,777	(197)	(4,148)	(1,407)	0	0
SHAREHOLDERS' EQUITY	(555,078)	(968,151)	(1,323,428)	174,337	344,925	367,337	315,593
NON-CURRENT LIABILITIES	809,191	1,453,852	90,989	95,514	93,484	59,822	50,436
Financial liabilities	750,661	1,328,338	35,216	32,344	7,798	0	0
Subordinated liabilities	0	0	0	0	0	0	0
Severance payments fund	27,832	32,511	15,210	15,651	18,393	19,015	18,270
Deferred tax liabilities	5,977	60,598	10,545	20,740	33,762	9,267	12,661
Other liabilities	24,721	32,405	30,018	26,779	33,531	31,540	19,505
CURRENT LIABILITIES	2,671,723	675,957	2,022,639	273,183	337,304	259,551	241,405
Financial liabilities	760,981	201,653	1,623,178	7,428	41,996	59	2,195
Subordinated liabilities	1,369,500	0	0	0	0	0	0
Trade payables	192,608	177,938	149,796	94,216	137,713	111,027	101,113
Provisions	51,113	55,392	71,705	26,865	36,048	33,798	35,966
Tax liabilities	17,995	28,670	26,062	14,318	4,926	4,260	5,798
Deposits and deferred income	279,526	212,304	151,898	130,356	116,621	110,407	96,333
Liabilities connected to AfS	907	250	50,353	250	205	13,926	0
TOTAL EQUITY AND LIABILITIES	2,926,743	1,161,908	840,553	523,284	775,918	700,636	607,434

APPENDIX 2/A: DATA FROM RESTATED SPG-IOL FINANCIAL STATEMENTS

YEARS	2003	2004	2005	2006	2007	2008	2009	2010
TOTAL REVENUES	1.451.631	1.410.100	1.430.580	1.465.690	1.449.049	1.369.431	1.214.475	1.039.214
Cost of raw materials and services	(552.882)	(518.096)	(518.996)	(573.279)	(504.141)	(471.639)	(406.166)	(381.083)
Cost of labour	(223.545)	(209.216)	(219.128)	(231.921)	(242.615)	(236.663)	(218.176)	(199.490)
Other operating costs	0	(3.753)	(5.237)	(4.975)	(4.756)	(5.493)	(4.530)	(3.757)
EBITDA	675.204	679.035	687.219	655.515	697.537	655.636	585.603	454.884
Provisions	(72.868)	(64.653)	(60.659)	(47.180)	(49.952)	(58.481)	(58.002)	(38.388)
Depreciations	(16.754)	(14.579)	(13.718)	(13.234)	(14.783)	(14.782)	(15.951)	(14.575)
Amortization of Operating Intangibles	(17.994)	(15.711)	(18.673)	(20.035)	(27.034)	(33.031)	(47.245)	(50.483)
EBITA	567.588	584.092	594.169	575.066	605.768	549.342	464.405	351.438
Impairments of goodwill	(90.102)	0	0	0	0	(130.793)	(91.297)	(673.816)
Amortization of MKTG related Intangibles	(147.301)	(168.754)	(162.067)	(162.067)	(162.067)	(164.414)	(97.667)	(11.763)
EBIT	330.185	415.338	432.102	412.999	443.701	254.135	275.441	(334.141)
Restructuring expenses	(39.818)	(4.645)	(764)	(6.432)	(10.299)	(25.611)	(23.575)	(38.349)
Extraordinary Income (Costs)	(3.169)	(28.316)	(3.237)	319	(4.201)	395	(5.911)	(2.295)
Cost of Stock options	0	(3.005)	(7.907)	(4.768)	(1.497)	(572)	(227)	(60)
OPERATING RESULT	287.198	379.372	420.194	402.118	427.704	228.347	245.728	(374.845)
Income (losses) from AfS	(27.202)	0	175	0	1.108	(84.625)	(12.337)	(240)
Result from equity investments	1.593	6.576	4.243	(5)	(3.314)	(5)	36	35
Financial income	12.384	4.798	7.722	10.129	16.098	15.671	7.155	5.431
Financial expenses	(138.553)	(253.055)	(272.008)	(256.202)	(256.651)	(258.805)	(225.263)	(259.597)
Foreign Currency effects	(565)	(2.702)	3.718	(136)	775	(5.073)	3.225	207
Income from debt restructuring								
Taxes	(117.256)	(48.930)	(25.383)	(74.116)	(79.482)	(69.190)	(54.173)	(87.938)
NET INCOME (LOSS)	17.599	86.059	138.661	81.788	106.238	(173.680)	(35.629)	(716.947)

YEARS	2011	2012	2013	2014	2015	2016	2017
TOTAL REVENUES	961.792	659.008	507.931	412.133	449.554	393.507	340.490
Cost of raw materials and services	(366.580)	(275.671)	(267.164)	(253.720)	(271.934)	(206.069)	(182.543)
Cost of labour	(181.607)	(91.789)	(105.922)	(95.292)	(109.748)	(99.782)	(77.599)
Other operating costs	(4.449)	(2.579)	(3.622)	(3.467)	(2.117)	(3.393)	(2.683)
EBITDA	409.156	288.969	131.223	59.654	65.755	84.263	77.665
Provisions	(38.519)	(60.087)	(41.732)	(27.026)	(21.630)	(20.316)	(10.004)
Depreciations	(13.808)	(9.070)	(22.730)	(7.667)	(6.643)	(5.905)	(3.781)
Amortization of Operating Intangibles	(48.587)	(38.773)	(36.798)	(32.682)	(42.886)	(42.189)	(26.900)
EBITA	308.242	181.039	29.963	(7.721)	(5.404)	15.853	36.980
Impairments of goodwill	(696.284)	(1.327.625)	(88.947)	(4.619)	0	0	0
Amortization of MKTG related Intangibles	(2.574)	(509.114)	(129.421)	(4.953)	(4.635)	(6.010)	(5.228)
EBIT	(390.616)	(1.655.700)	(188.405)	(17.293)	(10.039)	9.843	31.752
Restructuring expenses	(42.007)	(89.932)	(42.058)	(11.737)	(42.353)	(8.044)	(5.110)
Extraordinary Income (Costs)	(396)	(10.902)	(3.993)	3.494	25.420	(1.060)	1.119
Cost of Stock options	0	0	0	0	0	0	0
OPERATING RESULT	(433.019)	(1.756.534)	(234.456)	(25.536)	(26.972)	739	27.761
Income (losses) from AfS	0	4.294	3.733	(18.428)	222	0	0
Result from equity investments	(378)	0	0	(2.648)	(6.618)	(1.499)	0
Financial income	3.776	5.465	2.659	2.221	1.860	2.555	1.320
Financial expenses	(273.472)	(147.353)	(132.858)	(130.565)	(4.459)	(2.442)	(623)
Foreign Currency effects	1.309	0	(52)	(8)	0	(44)	(16)
Income from debt restructuring		669.690		1.565.052	5.887		
Taxes	(87.184)	174.884	13.174	(15.069)	13.660	23.341	(2.025)
NET INCOME (LOSS)	(788.968)	(1.049.554)	(347.800)	1.375.019	(16.420)	22.650	26.417

APPENDIX 2/B: DATA FROM RESTATED SPG-IOL BALANCE SHEETS

YEARS	2003	2004	2005	2006	2007	2008	2009	2010
Trade receivables	754.713	684.297	669.740	668.681	671.101	671.014	621.601	613.088
Inventory	12.890	10.313	12.444	11.891	15.703	15.211	10.482	10.399
Trade payables	(273.333)	(274.257)	(292.754)	(292.919)	(276.814)	(256.993)	(228.947)	(207.593)
Working cash	29.033	28.202	28.612	29.314	28.981	27.389	24.290	20.784
Net deferred income and prepaid expenses	(51.154)	(45.829)	(43.724)	(38.123)	(50.080)	(50.115)	(35.520)	(221.566)
TRADE WORKING CAPITAL	472.149	402.726	374.318	378.844	388.891	406.506	391.906	215.112
Net tax credits (liabilities)	(174.488)	(26.751)	(34.691)	(18.294)	(33.359)	(65.748)	(30.882)	(46.353)
Current Provisions	(74.027)	(60.890)	(50.366)	(39.259)	(44.165)	(52.460)	(49.928)	(45.637)
NET WORKING CAPITAL	**223.634**	**315.085**	**289.261**	**321.291**	**311.367**	**288.298**	**311.096**	**123.122**
Tangible assets	42.579	35.697	49.648	50.013	56.198	106.602	97.380	88.662
Operating intangible assets	44.465	34.849	43.965	67.200	91.269	96.264	93.348	77.182
OPERATING FIXED CAPITAL	87.044	70.546	93.613	117.213	147.467	202.866	190.728	165.844
Other non-current assets	0	1.413	1.126	805	326	344	993	746
Non-current Provisions	0	(4.167)	(3.323)	(576)	(1.343)	(4.012)	(6.641)	(13.604)
DTA/DTL on operating items	98.843	70.239	57.574	50.706	54.008	47.745	49.555	88.824
Non-current Tax credits	1.668	0	0	0	0	0	0	0
NON-CURRENT ASSETS AND LIABILITIES	100.511	67.485	55.377	50.935	52.991	44.077	43.907	75.966
OPERATING INVESTED CAPITAL	**411.189**	**453.116**	**438.251**	**489.439**	**511.825**	**535.241**	**545.731**	**364.932**
Goodwill and marketing related intangibles	4.513.027	4.307.825	4.154.998	3.997.672	3.943.671	3.517.486	3.335.257	2.651.255
Deferred tax assets/liabilities on goodwill	0	(68.733)	(73.839)	(114.358)	(50.019)	(53.564)	(28.649)	(29.054)
OPERATING INVESTED CAPITAL + GOODWILL	**4.924.216**	**4.692.208**	**4.519.410**	**4.372.753**	**4.405.477**	**3.999.163**	**3.852.339**	**2.987.133**
Non-operating assets	26.700	7.073	3.971	3.203	11.927	6.444	4.464	4.160
Held for sale assets/liabilities	0	0	0	0	0	876	74	(250)
DTA/DTL on losses and non-operating assets	0	74.511	116.043	111.998	5.265	2.093	5.628	7.666
NON-OPERATING ASSETS	26.700	81.584	120.014	115.201	17.192	9.413	10.166	11.576
TOTAL INVESTED CAPITAL	**4.950.916**	**4.773.792**	**4.639.424**	**4.487.954**	**4.422.669**	**4.008.576**	**3.862.505**	**2.998.709**

YEARS	2003	2004	2005	2006	2007	2008	2009	2010
Excess cash	(136.898)	(109.675)	(173.546)	(278.881)	(175.568)	(277.213)	(267.702)	(220.944)
RBS bank loan	528.328	2.684.194	2.444.841	2.059.552	1.834.431	1.671.976	1.390.320	649.974
Lighthouse International loan	0	1.266.737	1.270.272	1.275.924	1.281.576	1.286.845	1.287.427	1.293.398
Senior Secured Bonds	0	0	0	0	0	0	0	728.220
Financial leasing	0	0	0	0	0	56.458	54.911	52.202
Securitization of receivables	0	0	0	254.653	258.768	258.865	256.930	190.000
Other current financial liabilities	27.274	1.705	25.814	23.144	30.839	51.086	29.878	15.589
Other non-current financial liabilities	105.170	98	63	126	266	93	5.395	0
NET FINANCIAL POSITION	**523.874**	**3.843.059**	**3.567.444**	**3.334.518**	**3.230.312**	**3.048.110**	**2.757.160**	**2.708.439**
Severance payments funds	52.519	70.777	72.246	78.006	68.527	56.925	66.082	61.616
NFP+DEBT EQUIVALENT	**576.393**	**3.913.836**	**3.639.690**	**3.412.524**	**3.298.839**	**3.105.035**	**2.823.242**	**2.770.055**
GROUP EQUITY	4.369.172	850.168	980.117	1.057.184	1.100.006	876.595	1.017.352	213.590
MINORITY INTERESTS	5.351	9.788	19.617	18.246	23.824	26.946	21.911	15.064
TOTAL SOURCE OF FINANCING	**4.950.916**	**4.773.792**	**4.639.424**	**4.487.954**	**4.422.669**	**4.008.576**	**3.862.505**	**2.998.709**

YEARS	2011	2012	2013	2014	2015	2016	2017
Trade receivables	520.797	360.528	229.815	182.830	197.070	161.786	137.794
Inventory	10.409	9.862	4.458	3.927	3.789	2.210	1.279
Trade payables	(192.608)	(177.938)	(149.796)	(94.216)	(137.713)	(111.027)	(101.113)
Working cash	19.236	13.180	10.159	8.243	8.991	7.870	6.810
Net deferred income and prepaid expenses	(217.446)	(155.200)	(112.842)	(92.022)	(73.274)	(76.263)	(68.519)
TRADE WORKING CAPITAL	140.388	50.432	(18.206)	8.762	(1.137)	(15.424)	(23.749)
Net tax credits (liabilities)	9.242	(4.912)	(4.276)	19.530	24.423	8.988	13.695
Current Provisions	(51.113)	(55.392)	(71.705)	(26.865)	(36.048)	(33.798)	(35.966)
NET WORKING CAPITAL	**98.517**	**(9.872)**	**(94.187)**	**1.427**	**(12.762)**	**(40.234)**	**(46.020)**
Tangible assets	84.546	67.765	40.047	34.755	18.380	8.654	9.430
Operating intangible assets	67.107	164.570	101.275	95.803	60.367	39.622	34.437
OPERATING FIXED CAPITAL	151.653	232.335	141.322	130.558	78.747	48.276	43.867
Other non-current assets	676	5.530	5.862	1.199	2.314	499	434
Non-current Provisions	(4.152)	(7.834)	(7.182)	(2.296)	(14.760)	(12.257)	(503)
DTA/DTL on operating items	48.638	51.956	12.956	424	12.517	22.456	20.920
Non-current Tax credits	0	0	0	4.518	4.518	23.061	23.418
NON-CURRENT ASSETS AND LIABILITIES	45.162	49.652	11.636	3.845	4.589	33.759	44.269
OPERATING INVESTED CAPITAL	**295.332**	**272.115**	**58.771**	**135.830**	**70.574**	**41.801**	**42.116**
Goodwill and marketing related intangibles	1.951.857	252.205	29.063	25.312	283.713	277.703	272.476
Deferred tax assets/liabilities on goodwill	(40.682)	(108.350)	(22.829)	(21.390)	(56.025)	(54.646)	(52.280)
OPERATING INVESTED CAPITAL + GOODWILL	**2.206.507**	**415.970**	**65.005**	**139.752**	**298.262**	**264.858**	**262.312**
Non-operating assets	5.900	4.424	3.054	13.841	6.789	6.190	6.266
Held for sale assets/liabilities	(305)	(250)	118.662	(250)	2.320	(2.125)	0
DTA/DTL on losses and non-operating assets	8.867	12.299	24	688	9.937	23.075	18.816
NON-OPERATING ASSETS	14.462	16.473	121.740	14.279	19.046	27.140	25.082
TOTAL INVESTED CAPITAL	**2.220.969**	**432.443**	**186.745**	**154.031**	**317.308**	**291.998**	**287.394**

YEARS	2011	2012	2013	2014	2015	2016	2017
Excess cash	(153.496)	(186.479)	(186.267)	(100.212)	(114.575)	(113.696)	(67.666)
RBS bank loan	740.250	663.873	703.435	0	0	0	0
Lighthouse International loan	1.369.500	0	0	0	0	0	0
Senior Secured Bonds	722.242	824.616	915.493	0	0	0	0
Financial leasing	49.336	41.502	39.466	37.320	8.916	0	0
Securitization of receivables	0	0	0	0	0	0	0
Other current financial liabilities	(186)	0	0	2.452	40.878	59	2.195
Other non-current financial liabilities	0	0	0	0	0	0	0
NET FINANCIAL POSITION	**2.727.646**	**1.343.512**	**1.472.127**	**(60.440)**	**(64.781)**	**(113.637)**	**(65.471)**
Severance payments funds	48.401	57.082	38.046	40.134	37.164	38.298	37.272
NFP+DEBT EQUIVALENT	**2.776.047**	**1.400.594**	**1.510.173**	**(20.306)**	**(27.617)**	**(75.339)**	**(28.199)**
GROUP EQUITY	(568.759)	(996.460)	(1.342.907)	174.429	295.472	367.337	315.593
MINORITY INTERESTS	13.681	28.309	19.479	(92)	49.453	0	0
TOTAL SOURCE OF FINANCING	**2.220.969**	**432.443**	**186.745**	**154.031**	**317.308**	**291.998**	**287.394**

APPENDIX 2/C: COMPUTATION OF SPG-IOL FREE CASH FLOWS

YEARS	2003	2004	2005	2006	2007	2008	2009	2010
EBITA	567.588	584.092	594.169	575.066	605.768	549.342	464.405	351.438
Adjusted operating taxes	(243.535)	(208.005)	(176.111)	(219.788)	(224.525)	(223.743)	(157.137)	(174.327)
NOPLAT	324.053	376.087	418.058	355.278	381.243	325.599	307.268	177.111
Provisions	(72.868)	(64.653)	(60.659)	(47.180)	(49.952)	(58.481)	(58.002)	(38.388)
Depreciations	16.754	14.579	13.718	13.234	14.783	14.782	15.951	14.575
Amortization of Operating Intangibles	17.994	15.711	18.673	20.035	27.034	33.031	47.245	50.483
GROSS CASH FLOW	431.669	471.030	511.108	435.727	473.012	431.893	428.466	280.557
Change in operating working capital		(156.104)	(34.835)	(79.210)	(40.028)	(35.412)	(80.800)	149.585
Net capital expenditure		(13.792)	(55.458)	(56.869)	(72.071)	(103.212)	(51.058)	(40.174)
Change in other operating items		33.026	12.108	4.442	(2.056)	8.914	170	(32.059)
GROSS INVESTMENT		(136.870)	(78.185)	(131.637)	(114.155)	(129.710)	(131.688)	77.352
FCF BEFORE INVESTMENT IN GOODWILL		**334.160**	**432.923**	**304.090**	**358.857**	**302.184**	**296.778**	**357.909**
Investment in goodwill (+DTL effect)		105.181	(4.134)	35.778	(172.405)	134.523	(31.650)	(1.172)
FCF AFTER GOODWILL		**439.341**	**428.789**	**339.868**	**186.452**	**436.707**	**265.128**	**356.737**
Investment in extra operating items		(54.884)	(38.430)	4.813	98.009	7.779	(753)	(1.410)
Extraordinary income and expenses		(35.966)	(11.908)	(10.881)	(15.997)	(25.788)	(29.713)	(40.704)
Gains and losses on equity investments		6.576	4.243	(5)	(3.314)	(5)	36	35
Gains and losses from foreign currencies		(2.702)	3.718	(136)	775	(5.073)	3.225	207
Gains and losses from available for sale		0	175	0	1.108	(84.625)	(12.337)	(240)
Non-operating taxes		159.075	150.728	145.672	145.043	154.553	102.964	86.389
NON-OPERATING CASH FLOW		72.099	108.526	139.463	225.624	46.841	63.422	44.277
CASH FLOW AVAILABLE TO INVESTORS		**511.440**	**537.315**	**479.331**	**412.076**	**483.547**	**328.550**	**401.014**
Proceeds from debt restructuring		0	0	0	0	0	0	0
Net financial expenses		(248.257)	(264.286)	(246.073)	(240.553)	(243.134)	(218.108)	(254.166)
Change in severance pay funds		18.258	1.469	5.760	(9.479)	(11.602)	9.157	(4.466)
Change in shareholders' equity		(3.598.934)	(1.956)	(3.069)	(55.577)	(43.765)	178.798	(85.615)
Change in minority interest		(1.692)	3.073	(3.023)	(2.261)	(2.844)	(7.447)	(8.047)
CHANGE IN NFP		**(3.319.185)**	**275.615**	**232.926**	**104.206**	**182.202**	**290.950**	**48.720**

YEARS	2011	2012	2013	2014	2015	2016	2017
EBITA	308.242	181.039	29.963	(7.721)	(5.404)	15.853	36.980
Adjusted operating taxes	(175.113)	(54.311)	(76.571)	(60.296)	6.243	19.136	(4.284)
NOPLAT	133.129	126.728	(46.608)	(68.017)	839	34.989	32.696
Provisions	(38.519)	(60.087)	(41.732)	(27.026)	(21.630)	(20.316)	(10.004)
Depreciations	13.808	9.070	22.730	7.667	6.643	5.905	3.781
Amortization of Operating Intangibles	48.587	38.773	36.798	32.682	42.886	42.189	26.900
GROSS CASH FLOW	234.043	234.658	54.652	(642)	71.998	103.399	73.381
Change in operating working capital	(13.914)	48.302	42.584	(122.640)	(7.441)	7.156	(4.218)
Net capital expenditure	(48.204)	(128.525)	31.485	(29.585)	2.282	(17.623)	(26.272)
Change in other operating items	30.804	(4.490)	38.016	7.791	(744)	(29.170)	(10.510)
GROSS INVESTMENT	(31.314)	(84.713)	112.085	(144.434)	(5.903)	(39.637)	(41.000)
FCF BEFORE INVESTMENT IN GOODWILL	**202.729**	**149.945**	**166.736**	**(145.076)**	**66.094**	**63.762**	**32.381**
Investment in goodwill (+DTL effect)	12.168	(69.419)	(80.747)	(7.260)	(228.401)	(1.379)	(2.367)
FCF AFTER GOODWILL	**214.897**	**80.526**	**85.989**	**(152.336)**	**(162.307)**	**62.383**	**30.014**
Investment in extra operating items	(2.886)	(2.011)	(105.267)	107.461	(4.767)	(8.094)	2.058
Extraordinary income and expenses	(42.403)	(100.834)	(46.051)	(8.243)	(16.933)	(9.104)	(3.991)
Gains and losses on equity investments	(378)	0	0	(2.648)	(6.618)	(1.499)	0
Gains and losses from foreign currencies	1.309	0	(52)	(8)	0	(44)	(16)
Gains and losses from available for sale	0	4.294	3.733	(18.428)	222	0	0
Non-operating taxes	87.929	229.195	89.745	45.227	7.417	4.205	2.259
NON-OPERATING CASH FLOW	43.571	130.644	(57.892)	123.361	(20.679)	(14.536)	310
CASH FLOW AVAILABLE TO INVESTORS	**258.468**	**211.170**	**28.098**	**(28.975)**	**(182.985)**	**47.847**	**30.324**
Proceeds from debt restructuring	0	669.690	0	1.565.052	5.887	0	0
Net financial expenses	(269.696)	(141.888)	(130.199)	(128.344)	(2.599)	113	697
Change in severance pay funds	(13.215)	8.681	(19.036)	2.088	(2.970)	1.134	(1.026)
Change in shareholders' equity	7.401	630.841	1.156	138.169	133.684	49.215	(78.161)
Change in minority interest	(2.165)	5.640	(8.633)	(15.423)	53.324	(49.453)	0
CHANGE IN NFP	**(19.207)**	**1.384.134**	**(128.614)**	**1.532.567**	**4.341**	**48.856**	**(48.166)**

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