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Asia Aluminum vs FerroChina – A Tale of 2 PRC Restructurings

Asia Aluminum ("AA") and FerroChina have been the highlights of a surprisingly slow year for PRC restructurings.

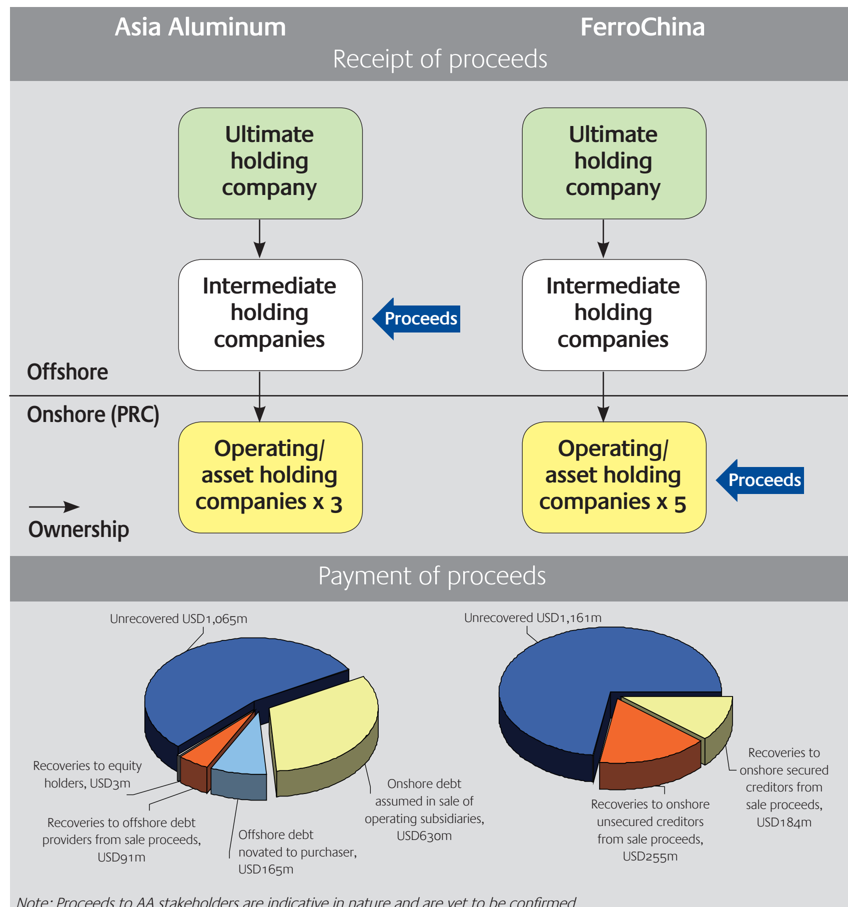
Whilst the jury is still out (and may remain out) on which case provided the most efficient and effective method of recovery, in this article of FFA we discuss the key factors which should be taken into account when considering the risks of any investment with PRC exposure and how to maximise the chances of a return in an insolvency scenario, no matter which jurisdiction insolvency proceedings are conducted.

Stakeholder recoveries

Whilst the groups were similar in size, nature of operations, group structure and cause of distress, the circumstances surrounding recovery to stakeholders were significantly different. One pursued the more familiar Hong Kong liquidation system, whilst the other tackled the unknown maze of the PRC bankruptcy law.

One thing is clearly evident from our research; administration proceedings involving PRC assets cannot be dealt with uniformly. Different circumstances and limitations faced by the administrators of each case necessitated the need for flexible solutions in order to achieve returns to stakeholders.

The percentage of total debt outstanding that is expected to be recovered is around 45% and 30% for AA and FerroChina respectively, however as the adjacent charts show, the method of recovery varies.



Note: Proceeds to AA stakeholders are indicative in nature and are yet to be confirmed.

AA and FerroChina will not be the last businesses with Chinese operations to experience financial difficulties. Therefore, whilst the new PRC Bankruptcy Law is maturing (in a way that only comes with experience gained through trial and error), a 'horses for courses' approach will be required for dealing with distressed PRC companies.

Lend where the assets are

This has been said before and seems can't be said enough – lend where the assets are. Whilst administration proceedings of the two cases were carried out in different jurisdictions, they illustrated key ways for creditors to maximise their opportunity for a return in an insolvency scenario:

- Secure your lending against hard assets; and
- Lend where the assets are.

These cases are certainly not isolated in highlighting the importance of this.

In both cases, lenders that obtained security over fixed assets received (or are expected to receive) a 100% return. We recognise however that not all loans can be secured. Therefore, where lenders cannot obtain security, they should seek to ensure they lend where the underlying assets are. Unsecured lenders to the operating assets of both AA and FerroChina achieved substantially superior returns compared to the lenders to the holding companies.

In the case of AA, the equity of three PRC operating entities was sold. This meant that the debt and payables of these entities was effectively assumed by the purchaser, providing a possible 100% return for onshore unsecured creditors (providing of course the companies do not suffer liquidity problems under their new ownership). In the case of FerroChina, unsecured lenders to the operating companies are to receive a return from the proceeds of the sale of the same operating companies.

Where lenders cannot obtain security over hard assets or lend where the assets are, they should seek alternative types of security within a corporate group structure that minimises return leakages in an insolvency scenario. Whilst Senior Note Holders of both AA and FerroChina lent to offshore holding companies, both obtained guarantees from and share pledges over, subsidiary companies. Furthermore, Note Holders in AA obtained security over offshore intercompany loan accounts. These types of security ensured that value that flowed offshore, as it did in the case of AA, flowed (largely) directly to the Note Holders rather than as dividends through the group structure where leakage may occur to other unsecured creditors and minority interests.

Understand the risk profile of the business you are investing in – it may not be uniform

The AA case in particular, highlighted the need for investors to understand the underlying risk profile of the business they were investing in. AA had two main product lines, extruded and flat rolled aluminium products. At first glance, their risk profiles may not seem significantly different, both being subject to similar demand forces and supply factors. However, one product line was operational, management had an extensive track record of running similar businesses and it had a profitable history of operation. The other was still under construction, was 18 months behind its initial completion date at the time of the provisional liquidation, significantly over budget and management was untested in operations of this type. Should investors and lenders seek the same return from these business lines?

Minority equity investors of AA recognised this difference and sought to implement measures to 'ring fence' the profitable operations. They invested in a group company that was only exposed to the profitable operations whilst also placing various clauses in the shareholders agreement to restrict the use of funds generated from these operations. However, to enable them to have the opportunity to gain exposure to the upside of the new business line, they also negotiated an equity swap mechanism into a holding company higher up the corporate structure that had interests in both business lines. By doing so, they minimised the risk of their initial investment, yet provided a mechanism for possible increased future returns.

In listed investments, investors can easily dispose of their interests if management's actions increase the overall risk profile of the investment. However, in less liquid investments, investors need to understand the risks of the business and ensure they are protected against changes in the risk profile of their original investment, i.e ensure returns are commensurate with the risk.

Remember the bad times – sensitivity analysis of the downside

When economic times are good, and good for extended periods (as they were for a number of years leading into 2008), the bad times are often forgotten as is (unfortunately) analysis of an investment's downside risk. When performing due diligence prior to making an investment, a stress test of the company is vital.

Similarly, investors should continue to monitor the current and future cash flow needs of the business. Does the company have sufficient cash resources to survive a major shock to the industry or general economy?

Both AA and FerroChina had major drains on their cash resources prior to their failure. For AA, it was the construction of their flat rolled product line, whilst FerroChina expanded production capacity via the acquisition of new subsidiaries. Whilst each company's profitable operations could sustain these drains in the good times, when things turned down they placed significant stress on their cash resources.

Understand the relationships between 'key men' and local government

In the PRC, relationships with government can play a significant role in the success of a company and may also impact the recovery options in an insolvency scenario.

Experience shows that above all, in the event of an insolvency involving PRC companies, local government's primary aim is to maintain social stability. AA and FerroChina were no different in this regard. Both were significant employers in their regions and, as such, the relevant governments had a strong motive to ensure operations continued.

In AA's case, the local government sought to prevent the destruction of value by negotiating a stay of local creditors and convincing local banks to allow AA to continue to draw on its working capital facilities to prevent a 'freezing order' frenzy. This allowed

operations to continue, (albeit at substantially lower capacity), whilst a restructuring option could be negotiated.

The local government in the FerroChina case paid employees to stay at home and temporarily shut down operations whilst a solution could be found.

Where the difference lies is the relationships between the 'key men' and the local government, which ultimately may have had a significant impact on the result achieved.

AA's founder and existing management had strong ties with local government. The founder was born in the area and had an extended family network operating many related businesses in the region. Therefore it was not difficult to ascertain that local government would likely and ultimately did prefer a buyout led by current management, making it immensely difficult for any other buyer to make a successful bid.

By contrast, local government ties with the 'key men' of FerroChina were not deep. They were foreigners and fled the PRC once the financial difficulties arose. Remaining management proved unhelpful to local government in the initial stages of recovery, thereby leading to the appointment of administrators who were able to introduce an external investor.

Both cases highlight that given the importance of relationships in the PRC and relative immaturity of the PRC bankruptcy law, relationships of 'key men' must be a key item for due diligence before an investment is made.

Conclusion

A closer look at the cases of AA and FerroChina highlight one important factor – the need for flexible solutions for insolvency scenarios of companies with PRC interests. No two cases will be the same and therefore there is no prescriptive solution to obtain a return for stakeholders. However, through a full understanding of risks of an investment (due diligence), recognising what the assets are and where they are (stay close), stakeholders can take measures to increase their returns if matters do go awry.

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Quick Comparison	Asia Aluminium	FerroChina
Location of income generating operations/ assets		
Offshore (foreign) vs Onshore (PRC) debt mix	Offshore debt 68% Onshore debt 32%	Offshore debt 13% Onshore debt 87%
Alternative attempts to solve liquidity issues prior to insolvency proceedings	**Introduction of new investor** → No investors genuinely interested **Tender offer** Tender offer to buy back notes issued by offshore entities of the Group at a discount → Failed due to rushed process and lack of transparency	**Introduction of new investor** → No investors genuinely interested **Refinance** Refinance covenant-breaching loans through issuance of a private placement bond → Administration proceedings commenced before the commitments could be delivered to the Group
Reasons for distress	■ Significant cash drain from, among other things, cost overruns and delay in completion of construction of flat rolled aluminium products plant ■ Inability to fund working capital requirements due to the effect of the Global Financial Crisis (decreased demand, lower selling prices) ■ High gearing levels	■ Sharp fall in export steel price ■ Locked-in high purchase costs of raw material ■ Significant cash drain from accquisition of new subsidiaries to increase production capacity ■ Collapse of the worldwide property market during the Global Financial Crisis ■ Failure to find a new investor
Jurisdiction of insolvency proceedings		
Type of insolvency proceedings	Provisional Liquidation in HK	PRC bankruptcy
Administrators' access to information / transparency of information	Low – management initially sought to restrict information flow however ultimately provided sufficient information to enable assessment of options and for other possible investors	High – full access to the information was provided on site once the plant was taken over by the Administrator
Key method of recovery to stakeholders	Sale of equity in operating entities from offshore holding companies via a stalking horse procedure	Sale of PRC operating entities and restructured debt
Method of deal approval	Hong Kong Court, with 100% creditor support from informal vote	PRC Court, with sufficient creditor support from formal vote
Overall average return to creditors as a % of outstanding debt	Unrecoverable 55% Recoverable 45%	Unrecoverable 70% Recoverable 30%
Timing of stakeholder returns	February 2010 (estimated) for offshore creditors	Installments over four years (2009-2012)
Outstanding risks to stakeholders	Onshore debt was assumed by the purchaser and some offshore debt novated. Whilst potentially able to recover 100%, these debt providers are exposed to the risk that the purchaser will be unable to meet future servicing and repayment obligations	The restructured debt is to be paid in phases over four years. Creditors will receive their returns over the same period and are therefore subject to the risk that the purchaser will be unable to meet the payments