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CORPORATE RESTRUCTURING: CASE STUDY OF A DISTRESSED COMPANY

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Introduction

Corporate restructuring is an undertaking taken by a corporation to substantially alter its financial structure or operations. In particular, corporate restructuring occurs when a company is having serious difficulties and is in financial distress.The mechanism of corporate restructuring is regarded as critical in order to eradicate financial meltdown and improve the company's efficiency. The concerned business employs a financial and legal specialist for advice and guidance in the negotiation and transaction dealings. A company indulging in such practices is often referred to as "distressed companies". When a corporation is in distress, it would be struggling to meet or has trouble settling its financial commitments to its creditors, usually due to high fixed costs, or sales that are vulnerable to economic crisis.Persistently low sales, diminishing margins, high debt, rapidly increasing interest costs, working capital interruption, rising customer and employee turnover are among the indicators of financially troubled firms.

It is important to understand the reasons for which distressed companies go for corporate restructuring.Lack of profitability is primary reason why companies seek corporate restructuring. It is also initiated when there is a shift in strategy, i.e. when the distressed entity's management tries to increase its efficiency by removing those departments and branches that do not comply with the business's key objective.The venture may not generate sufficient profit to support the firm's capital structure and may result in financial loss. The distressed angle of the company is tested based on various parameters like: Profitability over the past few years, operating costs of the company, liquidity available, capital structure, bonds trading in the market etc. The concept of Corporate Restructuring could be better understood by undertaking case study in detail of a Distressed Company, XYZ Environmental Ltd. The actual name of the company has been concealed to maintain confidentiality.

Company Overview

Founded in 2007, XYZ Environmental Ltd. is the diversified environmental services company in North America, providing a comprehensive line of non-hazardous solid waste management, infrastructure & soil remediation and liquid waste management services through its platform of facilities throughout Canada and 27 US states.The Company operates through three segments which are: Solid waste (77.6% of FY20 revenue), Infrastructure and soil remediation (12.6% of FY20 revenue) and Liquid waste (9.8% of FY20 revenue).

- **Solid Waste:** includes the collection, transportation, transfer, recycling and disposal of non-hazardous solid waste for municipal, residential, and commercial and industrial customers.
- **Infrastructure & Soil Remediation:** provides remediation of contaminated soils as well as complementary services, including civil, demolition, excavation and shoring services. Serves many major infrastructure customers
- **Liquid Waste Management:** Provides water waste collection and processing, UMO collection, processing and resale, hydro vaccum services, waste packaging, lab packaging and on site industrial services.

In FY20, the Company generated 47.6% of its revenue from Canada and 52.4% from US region.

XYZ has strategically located network of facilities across Canada and in 27 states in the US, providing services to more than 135,000 commercial and industrial customers and more than 4 million households.

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As of December 31, 2020, the Company had:

- 195 collection operations, over 150 transfer stations, 88 landfills, over 28 MRFs and 15 organics facilities
- 11 soil remediation facilities
- 75 liquid waste collection, processing or storage facilities
- In response to the spread of COVID-19 and resulting governmental measures, the Company has implemented business continuity initiatives:
- Deferred certain non-essential capital expenditures originally planned for 2020
- Reduced or eliminated certain discretionary costs such as travel and entertainment

Headquartered in Vaughan, Ontario, XYZ employed 15,475 people as of 31st December 2020. The Company is trading on 'The New York Stock Exchange (NYSE)' and 'The Toronto Stock Exchange (TSX)' under the ticker symbol 'XYZ'

Financial Summary

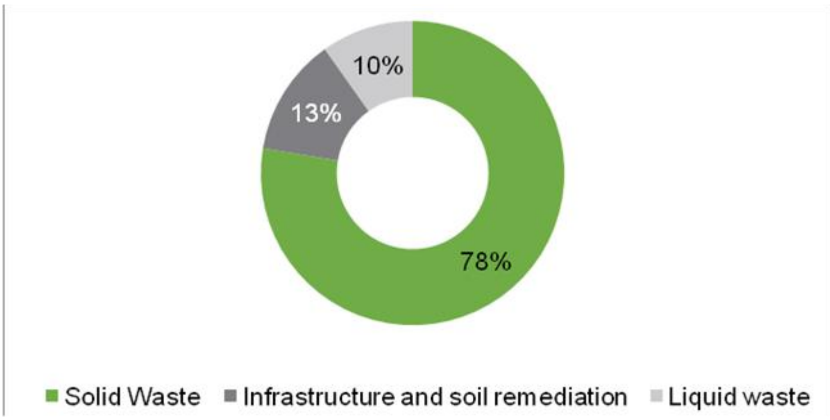
Below table presents the financials of the Company for the last 4 years[1]

Table 1

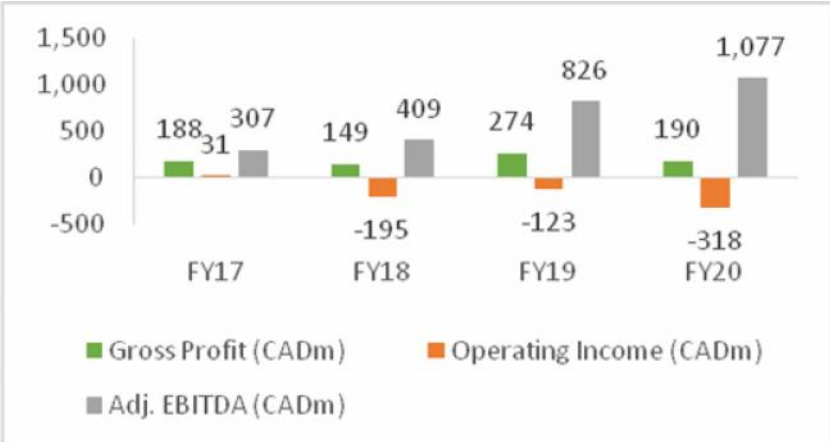
Summary of Financials (CADm)	**FY17**	**FY18**	**FY19**	**FY20**
Total Revenue	1,333	1,853	3,347	4,196
Cost of sales	1,145	1,704	3,073	4,006
Gross profit	188	149	274	190
Gross Profit Margin (%)	*14.1%*	*8.0%*	*8.2%*	*4.5%*
SG&A	157	344	397	508
SG&A as % of revenue	*11.8%*	*18.6%*	*11.8%*	*12.1%*
Operating income	31	(195)	(123)	(318)
Operating income margin (%)	*2.3%*	*(10.5%)*	*(3.7%)*	*(7.6%)*
Interest and other finance costs	213	370	532	598
Deferred purchase consideration	-	-	-	2
Loss on sale of property, plant and equipment	3	5	1	5
(Gain) loss on foreign exchange	(27)	56	(49)	(37)
Mark-to-market loss (gain) on TEU derivative purchase contract	-	-	-	449
Other	(17)	(1)	2	21
Loss before income taxes	(140)	(624)	(609)	(1,356)
Income tax (recovery) expense	(39)	(141)	(158)	(361)
Net income	(101)	(483)	(452)	(995)
Net income margin	*(7.6%)*	*(26.1%)*	*(13.5%)*	*(23.7%)*
Depreciation and amortization	239	413	799	1,238
EBITDA	270	218	677	919
EBITDA margin (%)	*20.3%*	*11.8%*	*20.2%*	*21.9%*
Adj. EBITDA	307	409	826	1,077
Adj. EBITDA margin (%)	*23.0%*	*22.1%*	*24.7%*	*25.7%*
Cash and cash equivalents	13	7	575	27
Operating Cash Flow – Capex	(77)	(193)	(207)	74
Capital structure	**FY17**	**FY18**	**FY19**	**FY20**
Total Revolving Credit	210	199	-	149
Total Term Loans	593	3,576	3,361	1,681
Total Senior Bonds and Notes	1,469	2,566	4,193	4,401
Total Lease Liabilities	13	64	192	191
Total adjustments	177	(116)	72	59
Total debt (on book value)	2,462	6,289	7,817	6,481
Total equity	509	3,193	2,768	5,679
Total capital	2,971	9,481	10,585	12,160

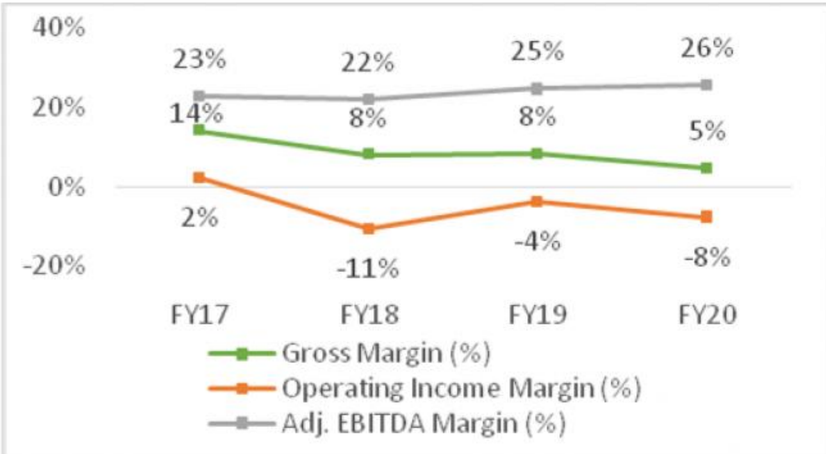
[1] Annual Reports of XYZ Environmental Ltd.

Revenue breakup by segment[1]: as of FY20 revenue



Profitability Analysis





Statistical Tools Used: Ratio Analysis, forecast analysis

Key takeaways:[2]

[1] Annual Report FY20, Pg 65

[2] Annual Report FY December 2020 of XYZ Environmental Ltd.

- **Revenue** for FY20 increased by 25.4% to CAD4,196m YoY primarily due to the impact of acquisitions. Other factors excluding the impact of acquisitions include:
  - Approximately 4.3% core pricing, surcharge and commodity price increases in solid waste business
  - Infrastructure & soil remediation revenue decreased by 6.2% due to a reduction in soil volumes processed at its facilities
  - Liquid waste revenues decreased by 16.1% due to a combination of lower sales volume of UMO and reduced industrial collection and processing activity resulting from the temporary suspension of certain customers' operations in response to COVID-19
- **Cost of Sales** increased by 30.4% YoY in FY20 mainly due to acquisitions, higher headcount related to the organic growth of business and an increase in insurance costs
  - The cost of additional safety equipment, hygiene products and cleaning services purchased during FY20 in response to COVID-19 also contributed to the increase in cost of sales
- **Gross profit** decreased by 30.6% in FY20 as compared to FY19
- **Selling, General & Administration (SG&A) expenses increased by 28.2% YoY in FY20** owing to:
  - The recognition of costs incurred in preparation of the IPO
  - An increase in share-based payments primarily related to options issued in connection with the IPO
  - Incremental salaries, benefits, information technology infrastructure investments and other costs related to the number and size of businesses acquired since January 1, 2019
- **Adjusted EBITDA** increased by 30.4% in FY20 as compared to FY19
  - **Solid Waste:** Adjusted EBITDA margin was 30.0% in FY20, an increase of 162 bps from FY19. The incremental revenue from acquisitions, primarily attributable to the recent acquisitions of Canada Fibers and solid waste collection businesses, contributed Adjusted EBITDA margins less than the existing base business
  - **Infrastructure & Soil Remediation:** Adjusted EBITDA margin was 17.4% in FY20, a decrease of 202 bps from 19.4% in FY19, due to delays in the acquisition of planned equipment purchases to support the growth of the infrastructure and soil remediation business resulting in increased equipment rental costs
  - **Liquid Waste:** Adjusted EBITDA margin was 23.6% in FY20, an increase of 108 bps from FY19, primarily attributable to the impact of cost control measures implemented to offset the impact of COVID-19, related volume decreases, and margin accretive acquisitions partially offset by lower sales volumes of UMO

Though the Company's revenue has increased over the period, it has been reporting net losses historically

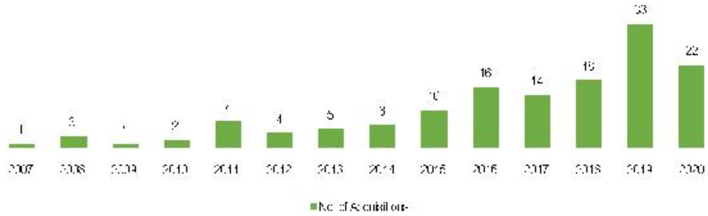
Recommendation

Basis the above financials, we observe that: Operationally, the Company is in a distressed situation as it has been running into losses since past 4 years despite of increasing revenues and acquisitions. The Company's SG&A expenses have been increasing continuously YoY and the Company has been reporting operating losses over the past 3 years. Hence, the Company should focus its efforts on:

- **'Optimizing operations and right size cost structure'** through:
  - Increasing its CNG vehicle count across segments to reduce cost on fuel and repair & maintenance.
  - Focus on developing existing customer relationships to unlock cross selling opportunities and acquire new customers.
  - Focus on developing in house landfills and disposal facilities as unable to access these third party facilities could serve to further increase in expenses and reduce profitability.
  - There is a potential for improvement in the SG&A costs through substantial investments in technology.

- **'Working Capital optimization'** through:
  - Fleet standardization leading to improved purchasing efficiency, reduced capital expenditure & maintenance turnaround time, and minimized parts inventory.

Acquisition history:[1]



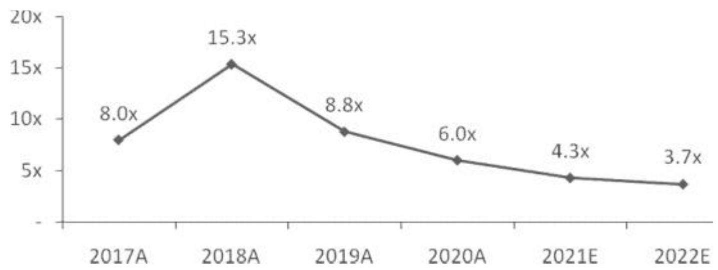
Capital Structure:[2]

The below table reflects the different tranches of debt which the Company had as of December 31, 2020.

Table 2

Debt instrument (As on 31st Dec-20)	Amount (CADm)*	Margin	Cum. Lev.
2023 CAD785m Revolving credit facility	149	Prime rate + 1.75% or L + 2.75%	0.1x
2025 USD1,312.9m Term loan	1,672	L + 3.00% or US prime rate + 2.00%	1.7x
2025 USD500m 4.250% senior secured notes	637	4.25%	2.3x
2025 USD750m 3.750% senior secured notes	955	3.75%	3.2x
2026 USD500m 5.125% senior secured notes	637	5.13%	3.8x
2028 USD750m 3.500% senior secured notes	955	3.50%	4.6x
2027 USD600m 8.500% senior unsecured notes	458	8.50%	5.1x
2028 USD500m 4.000% senior unsecured notes	637	4.00%	5.7x
Equipment loans and other	9	3.020% to 4.370%	5.7x
Tangible equity units amortizing notes	123	4.00%	5.8x
Lease obligations	191	7.42%	6.0x
Total debt	**6,422**		
Less: Cash	(27)		(0.0x)
Net debt	**6,395**		5.9x
FY20 Adj. EBITDA	1,077	DSCR	2.4x
FY20 Capex	428	Adj. DSCR	1.5x
Total liquidity	**664**		
Cash	27		
Undrawn RCF	636		

Leverage Progression[3]**:** Calculated as Net Debt/ Adjusted EBITDA



[1] Annual Report FY19, Pg 27 and Investor Presentation dated 23 February 2021,Pg 3

[2] Annual Report FY20, Pg158, 177, 182

[3] Forecasted figures for FY21 and FY22 are taken from broker report by BMO Capital Markets dated 23 February 2021

* Debt is considered on principal value

Analysis: Based on Table-2 and leverage progression chart, we observe the following:

- The company experienced a significant decrease in its leverage during FY20, as depicted in the leverage progression graph above
- The decrease was primarily driven by a decrease in debt during the FY20 period, while the adjusted EBITDA increased due to increase in revenue primarily attributable to the impact of acquisitions
- Debt decreased significantly as of Dec-20, as the Company used the net proceeds from the IPO to redeem certain senior notes and to repay certain indebtedness outstanding under RCF and Term Facility
- Debt primarily comprises of RCF, term loan, senior notes and capital lease
- Total debt is expected to decrease in FY21 and FY22, as the Company is committed to maintaining its leverage ratio in the mid-4x and refinance existing debt when required
- Although cash balance is expected to increase in FY21 and then decrease in FY22, it would still remain sufficient as the Company has no significant debt maturities before 2023
- EBITDA is expected to increase in FY21 and further in FY22, as the Company is evaluating a larger acquisition that could be completed in H2'21 as well as activity levels ramp up.

Bond Pricing:[1]

The Company has 6 bonds/notes trading on the TSXat the face value of 100. As observed from the chart:

- 8.500% Senior Unsecured Notes trade at a premium of 10.25
- 5.125% Senior Secured Notes trade at a premium of 5.50
- 4.250% Senior Secured Notes trade at a premium of 3.40
- 3.750% Senior Secured Notes trade at a premium of 1.41
- 3.500% Senior Secured Notes trade at a discount of 2.63
- 4.000% Senior Unsecured Notes trade at a discount of 2.85

Recommendation

Basis the above capital structure, leverage progression and bond pricing analysis, we observe that: the Company has sufficient liquidity to cater its debt obligations in the near-medium term. The Company's bonds are also trading above 90. Hence, the Company is not in a distressed shape from the Capital Structure standpoint.

Conclusion

Basis the above case study, it can be concluded that the Company shows signs of distress operationally. Hence it can focus its efforts on the following:

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1 S&P Capital IQ database

- Diversified Business Model:
  - Expansion in adjacent high growth product category, for instance, solid waste management which is projected to grow at a CAGR of 2.3% until 2023
  - Another, high growth product categories includes Liquid Waste
- Scale Expansion:
  - XYZ needs to focus on integrating of facilities to attain synergies
  - Both vertical as well as horizontal integration can be considered to expand scale of operations
  - XYZ should consider to diversify its business outside North America
- Optimize operations and right size cost structure
- There is a potential for improvement in the SG&A costs through substantial investments in technology
- Working Capital optimization through fleet standardization leading to improved purchasing efficiency, reduced capital expenditure & maintenance turnaround time, and minimized parts inventory

Abbreviations Used

EBITDA: Earnings before Interest, Tax, Depreciation and Amortization

CAD: Canadian Dollars

RCF: Revolving Credit Facility which is a form of credit issued by a financial institution that provides the borrower with the ability to draw down or withdraw, repay, and withdraw again

Bps: Basis points

DSCR: Debt Service Coverage Ratio which is a measurement of a firm’s available cash flow to paycurrent debt obligations

YoY: Year-on-Year

UMO: Used Motor Oil.

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