Corporate Restructure in South Africa

Since South Africa's return to the international community in the early 90's, financial markets in South Africa have undergone significant change and development. This has been driven internally by a number of political, social and economic factors, and externally by globalisation and increasing pressures to comply with international best practice in all spheres of operation.

Traditionally, the local liquidations market has been characterised by a highly "creditor-friendly" regulatory framework, which means that the creditors essentially drive and control the liquidations process, possibly to the detriment of the debtor who is facing liquidity problems.

Although we currently appear to be living through a relatively benign credit risk environment with few significant new high profile liquidations, one has only to cast one's mind back a few years, when there were almost daily media references to companies facing liquidation, potential job losses and formal enquiries. There is no doubt that if the economy hits a major downturn in the future, we will again be faced with the spectre of an increased numbers of companies facing critical liquidity and solvency issues, as well as a concomitant increase in liquidations, with all the associated socio-economic issues.

Recent high profile media coverage of some liquidations, such as Leisurenet and RAG, and the ever- increasing public spotlight on the roles of banks and other large creditors in the liquidation process, as well as the obvious undesirable socio-economic consequences for jobless workers, and failed businesses, have started forcing government, banks and the industry to consider what alternatives there are to existing practices and legislation.

Draft legislation has already provided for a process of regulated *rescue* (ie a controlled pre-liquidation restructure process), which is an attempt to address some of the shortcomings in our overly creditor-friendly regime, by providing for, amongst other things, possible moratoria on debt repayments, the appointment of a turnaround expert, formalised turnaround plans, etc. The effects of this would be to create a "rescue" situation, which would hopefully enable the distressed debtor company to recover itself and prevent its liquidation.

The potential hazards of this process would include issues such as *timing* – would a legalistic approach allow for timeous intervention, or would this just be another costly pre-liquidation expense? Secondly, there is a great risk that the appointment process would not be independent or would be open to abuse (ie no different from the current process); while thirdly, there would need to be a proper process of accreditation of the so-called "turnaround managers" to ensure that the appropriate skills, independence and experience are brought to bear in each situation. Finally, there may need to be a different approach to so-called "owner managed businesses", where the level and quantum of available resources in the company and its overall sophistication may not justify an expensive rescue plan. One might comment cynically that previous attempts at creditor protection and judicial management in South Africa (with a few specific exceptions) have, in the past, tended to fail for various reasons - nevertheless, the draft legislation should be seen in a positive light.

Apart from new legislation, I believe that another important motivator for change in the way corporates deal with critical liquidity problems and survival issues, will be the banks and other large creditors themselves.

In the current economic and socio/political environment, it is or will be, highly undesirable for banks particularly to be seen as “the bad guys” in any liquidation situation. In other words, banks, as typically the largest and most secure creditors, will need to be far more proactive in identifying distressed debtors, and acting to prevent the ultimate undesirable outcome of liquidation. Even where the banks themselves are not the creditors applying for liquidation, they tend to be seen as easy targets for public criticism.

Secondly, banks will need to find ways of intervening early to the benefit of both the creditors and debtor itself, without being seen to be compromising their integrity or independence. It is submitted that they would need to act in a responsible fashion well before any regulatory intervention, if they are to preserve their positions in the new legal environment, and avoid high profile media attention. Needless to say, there are pitfalls where a single creditor (such as a bank) takes the lead in commencing a non-regulated rescue plan, however, through early involvement of other creditors and proper communication and support of other stakeholders, I believe that contentious issues such as:

- allegations of bank interference in management;
- perceptions that banks somehow “guarantee” all debts in a rescue situation, and;
- perceptions of de facto control (Competition Commission violations);

could all be avoided.

The question is how banks and other large creditors would be able to do this? Experience has shown, particularly in the UK (where, until a few years ago, banks faced a very similar liquidations environment to South Africa today), that the banks started taking the initiative by appointing independent advisors to their debtor clients early on in a situation that was developing stress. Typically, these advisors have traditionally been people who were skilled in business diagnostics (ie being able to identify the real issues quickly) and turnaround implementation, often including “retired” liquidators.

The large UK accounting firms, with their global footprints, independence and wide range of accessible skills and experience, started to develop substantial “restructuring” practices, which became a natural fit between their traditional liquidations practices and their normal advisory practices (such as corporate finance). Pressure was - and still is - brought to bear by the banks on their debtors to employ these advisors early on, with the expectation that a substantial recovery would be far more likely had the earlier the problems been addressed, and far more beneficial to *all* stakeholders than a liquidation.

The successes of this approach have been many and substantial, which is credit to the logic of this approach, and the ability of banks to stand away dispassionately from their sometimes long client relationships, to force their hands in gaining debtor client acceptance. Indeed, many facility arrangements now contain clauses that allow banks to appoint advisors at certain trigger points *at the debtor’s cost.*

Historically, the South African banks have tended to try to manage their major “work-out” debtors on their own, or in consortium. Occasionally, they have succeeded in appointing “turnaround managers” to manage their troubled debtor customers, often with considerable success, but also at great cost. These managers would typically take over certain, or all, aspects of management in a “crisis type” fashion, and attempt to radically restore the company to solvency and/or liquidity, by ruthlessly cutting costs, eliminating inefficiencies and restoring focus. A number of people have built up reputations in the local market for success with this approach.

Banks have also occasionally used insolvency practitioners to make diagnostic assessments of a company’s position, but these are usually at the instance (and cost) of the bank, with little or no compliance or cooperation from the customer concerned. Therefore, my impression is that most distressed “corporate restructuring” related work in South Africa is currently carried out internally by the businesses themselves (rarely), but more usually by bank work-out departments, very often at a crisis stage in a corporate’s life.

It is my contention that local banks will need to reconsider their approach in this environment, to perhaps learn from the UK experience, and to take the initiative in proactively establishing a positive “restructure” environment, by using the many skilled restructure resources available in the local market. Furthermore, they should do so before waiting for the new legislation to come into effect - legislation that will impose yet further bureaucracy on an already over-burdened system. If the market identified distressed companies and acted early and decisively to fix these problems, costly regulated rescues could be avoided.

In conclusion, whilst we welcome any attempt to improve, through new legislation, the liquidations and recovery environment in South in South Africa, we feel that banks and other stakeholders and, indeed, debtor companies themselves, have an opportunity to play a very positive role by voluntarily obtaining independent expert advice early in a distress situation, and, by so doing, to contribute to the avoidance of high cost liquidations, joblessness and loss of confidence in the economy. Independent directors and audit committees should also not be afraid to seek independent advice where there are any concerns whatsoever about a company's viability.

KPMG South Africa is well positioned to assist banks and other financiers, large creditors and mid to large sized corporates in conducting diagnostic reviews, cash flow assessments and practical turnaround advice. For further information, please contact Richard Buchholz or Stefan Schwarzfischer in Johannesburg on 011 647- 7111, or Ben Durandt in Cape Town on 021 408-7048.

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