TMA

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Southern Africa

"one sucker required"

Corporate governance issues in business restructuring and turnaround management

Lecture presented by:

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GANDALF TRUST

MERGER & ACQUISITION SPECIALISTS

One sucker required – corporate governance issues in business restructuring and turnaround management.

Introduction

All businesses at some stage during their existence will go into a decline and lose money. The test for directors is to anticipate the decline and plan around it, or the business may quickly collapse due to no intervention. The decline and eventual collapse may be due to a number of reasons such as understating the competition, changes in market conditions, changes in technology, and a host of other conditions that occur from time to time within a business cycle.

This paper will deal with the following questions:

- What should be asked when a business goes into decline?
- What decisions must directors and shareholders make when a decline, sets in to avoid an outright collapse in a business?
- When and whom should directors and/or shareholders consult and where to find these experts?
- What aspects should be considered to successfully return a business to sustainable profitability?

Responsibilities and duties of Directors

A company is a juristic person, which operates through the action of the people within the company, and directed by the board of directors. The board, being the brains, directs the future course of the business by setting a strategy. The role of the board is to monitor the strategy by mentoring the executive management on the strategy and ensuring compliance in terms of the law and in terms of the practice of good corporate governance.

The board should operate as a cohesive collective to ensure the role of mentor occurs (King, code 2, 2002). This will enable the board to:

- Formulate the vision and the strategy for the company as well as guiding the affairs of the company and management;
- Make decisions based on mutual respect by directors of each other's skills.

The board must identify all risks and attempt to mitigate the potential risks by ensuring compliance and responsibility of the corporate citizen (King, code 2 and 3, 2002).

Directors' responsibility to avoid collapse and mitigate decline

It is the ultimate responsibility and duty of the directors to mitigate any decline in performance of the business, but to avoid the collapse of a business at all times. The following elements are usually present when a business has deteriorated from a decline (losing money, but can manage) to outright collapse (lost control):

- Bad Management – This is the lack of management to identify the risks and the lack of a contingency plan to manage those risks. (This does not necessarily imply bad business management, but rather the lack of having information at hand to make a decision).

- Emotional decision-making - Management makes various business decisions that are clouded by personal emotions and reasons. (Emotions are predominately motivated by greed and fear, while arrogance, jealousy, despair and depression contribute to erratic behaviour of decision makers).

- Lack of knowledge - Management does not understand or have the knowledge to identify or deal with a collapse. The events or symptoms during a collapse seem to be randomly chaotic to them. When dealing with a business that is in a state of collapse, the words often used are "what else can go wrong?" The management therefore makes increasingly reactive and shortsighted decisions, which accelerate the business in the state of collapse, increasing the chaos in all areas of the business.

With the ever-increasing responsibilities placed on directors, in terms of corporate governance and fiduciary duties, directors are faced with a dilemma of what to do, when a business is not performing well or losing money. The possibility of prosecution on a personal basis brings the agent relationship (between shareholders and management) into sharp focus, as directors are usually advised to place a company in liquidation as quickly as possible.

The board of directors must retain full and effective control over the company, monitor the executive management and ensure that the board deals with all material matters. (King: Code 2.1.3 to 2.1.7, 2002). It is the board, as a collective, that is ultimately accountable and responsible for the performance and affairs of the company. Delegating authority to board committees or management does not in any way mitigate or dissipate the discharge by the board and its directors of their duties and responsibilities. (King, Code 2.1.1,2002)

Considering the developments in Corporate Governance, the directors should follow a simple three-step plan:

- Recognise that the business or division is in decline, *(Risk identification)*
- Consult an expert (restructuring house or turnaround specialist) – i.e. a TMA member. *(Risk mitigation and management)*
- Inform and consult the shareholders as quickly as possible. *(Shareholder communication)*

Risk Identification

The board has to give effect, through mentorship and leadership, to the strategy and plans of the business. This also implies identifying and mitigating the existing and future risks of the business as contemplated by the King Report (King, Code3, 2002).

There are various methods that the board can follow in determining a strategy for the company and evaluating risks. A method proposed by the Chartered Institute of Management Accountants (CIMA) is "Enterprise Governance Framework" using a strategic scorecard.

- CIMA states that Enterprise Governance Framework provides a timely reminder to organisations to balance conformance requirements with the need to deliver long-term strategic success through performance. The strategic scorecard is not a detailed plan but is aimed at helping the board to ensure that all the aspects of the strategic process have been completed thoroughly. It helps the board to identify the decision points and then the timing of strategic options, milestones in strategic implementation together with the identification and mitigation of strategic risks. A number of complementary issues that would guide companies towards achieving robust corporate governance (conformance) and strategic success (performance) are:

    - *Enterprise risk management:*
      It is the recognition of a performance-driven approach, due to the ever-increasing change of pace, that has given rise to enterprise risk management. This reconciles both:

- The assurance requirements of the board and external stakeholders, i.e. that management understands the business risks and is managing them actively – conformance – and;
- The need to improve integrated risk management in decision-making activities at all levels – performance.

○ *The acquisition process* or *disposal of a loss making operation*
The strategic scorecard method has identified the following requirements for making successful acquisitions:

- Effective, experienced, full-time project management;
- Rigorous evaluation of synergies and ruthless implementation;
- Effective due diligence;
- Experienced specialists with recent deal experience;
- Early identification of risks with appropriate mitigating action.

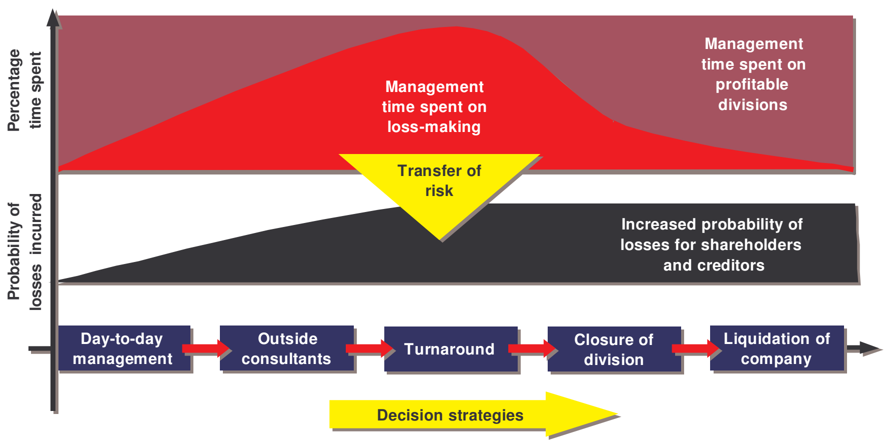
○ *Board performance*
The strategic scorecard highlights what new measures must be added to the existing guideline to evaluate the board performance to include issues such as:

- Performance evaluation of the board including the use of performance measurement systems;
- Board dynamics
- Board design.

Using these broad outlines an effective board should always be able to mitigate the risks associated with a decline. The ability to identify the risks is major step, to recognising that there is a problem and evaiding possible collapse.

Risk mitigation and management
Once the risks associated with decline have been identified, it is the board's responsibility to take action in this regard. At this stage, it is ego of the executive management that should be managed by the non-executive directors, to ensure that proper advice is obtained and correct decisions are made. Allowing the current executive management to manage the turnaround has the following risks:

Loss of Focus by Management during a Turmaround



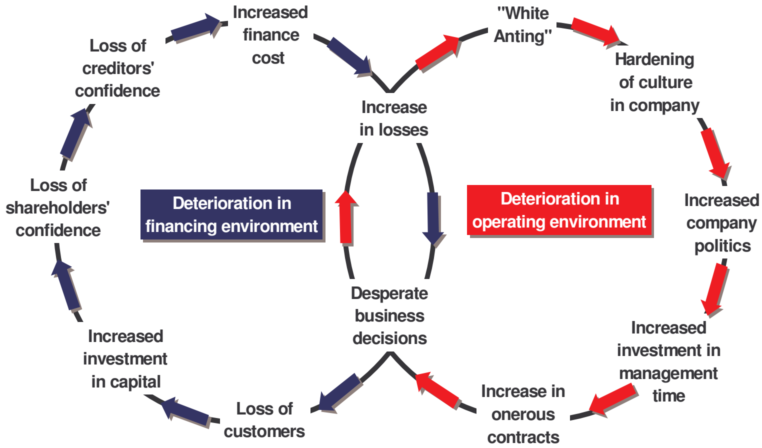
- No training or experience - Management is not trained to deal with business that is in a state of collapse or severe decline. They therefore gain "on the job training", by managing it as a turnaround.
- Loss of focus - If the management focuses on a loss making division, it increases the overall risk for the business and may lead to losses in other divisions.
- Deterioration of the business environment – Management is in conflict with various parties at the same time being
    - shareholders (more money required to fund the losses);
    - staff (work more for less or same pay); and
    - suppliers & banks (supply more credit).

It is the role of the board and especially the non-executive directors, to guide the business though a decline. The following options are available to the board:

- Consult and be educated - This can be achieved by consulting a turnaround expert to educate and enlighten the board about the problems associated with turnarounds.
- Devise a strategy -The board may further task the turnaround expert to devise the turnaround strategy of the business or part thereof.
- Implementation – After having considered the risks and the proposed strategy, the board (not the executive management) may task the turnaround expert to lead the turnaround.

Report back – The board should maintain ultimate control at all times, and not allow a layer to exist between the board and the turnaround expert.

The "turn-around environment" for management



A turnaround expert is considered to be a person that has suitable qualifications and experience and is recognised by a professional body such as TMA.

In general, boards need to ensure that they are making the most effective use of their knowledge and the limited time in order to achieve their stated objectives rather than simply complying with the letter of corporate governance codes.

Shareholder communication

A definition of “directors” was given by Jessel M.R. in *Re Forest of Dean Coal Mining Co.* (1878): “Directors have sometimes been called trustees, or commercial trustees, and sometimes they have been called managing partners, it does not matter much what you call them so long as you understand what their true position is, which is that they are really “*commercial men managing a trading concern for the benefit of themselves and of all the other shareholders in it”.* Directors have therefore a responsibility to act in the best interests of all shareholders.

Ultimately the board is collectively responsible to the members of the company and have an increasingly greater responsibility to other stakeholders (such as creditors and statutory requirements) (King, Code 5 and 7, 2002) to report and give an account of the activities and actions of the company to the various stakeholders (King, Code 2.1.15, Code 5 and Code 7, 2002).

A failure to communicate with shareholders timeously indicates an incompetent board, which may result in:

- A Loss of Confidence – Failing to convince shareholders that a constructive and well-defined plan has been devised and that board is in control. Losing shareholder confidence (i.e. share price), complicates managing the decline and hastens the impending collapse. Rumour mongering further compounds the problem, which not only undermines the shareholders, but also the confidence of the banks and suppliers.
- Risk of prosecution – Should the board fail to communicate the information in the market timely, they may be liable under the Securities Service Act No 36 of 2004, for manipulating the market price of a share. The directors may also be culpable of reckless trading and neglect of fiduciary duties as defined in terms of the Companies Act No 61of 1973 and Common Law.

A shareholder’s perspective (not owner operated)

Shareholders of public companies are very often fed-up with the management that is not producing the results that is required by them. The business belongs to shareholders, and though they are not allowed to deal with the assets of the company, they can deal with the board of directors of the company. The management of the company is the responsibility of the board.

Should the shareholders feel that the board is not performing, the board may be replaced. If the board fails to monitor and enforce (conformance) the board may be held responsible as a collective, in terms of their fiduciary responsibilities.

The problem that usually faces shareholders in South Africa is the lack of good management and the ability to swap that management for better management. Therefore it is my submission that managers charge a premium for their services, based not on their skills but on a lack of supply.

By the time shareholders are informed of the affairs of the business, it usually faces collapse, and the management is all ready looking for ways to “abandon ship” as quickly as possible and leave the shareholders to sort out the mess. The problem is that due to shortage of management, the shareholder usually is not able to fund or find management that wants to control a company in collapse. The reasons for this is simple:

- Experience and Skill - The management requires a vast set of skills and experience (which is at a premium in RSA);
- Risk of Prosecution – Should the business be placed in liquidation, the directors face various legal risks in his individual capacity.
- Risk of Failure - The risk of failure is extremely high and most professionals would not want to risk their reputations;
- Funding Requirement - To “yank a business out of collapse” requires extra resources (cash), which are not spent on assets, but on sorting out people and maintenance etc.

The losses therefore increase after a Turnaround professional becomes involved, as he understands that basics of the business should be attended to first.

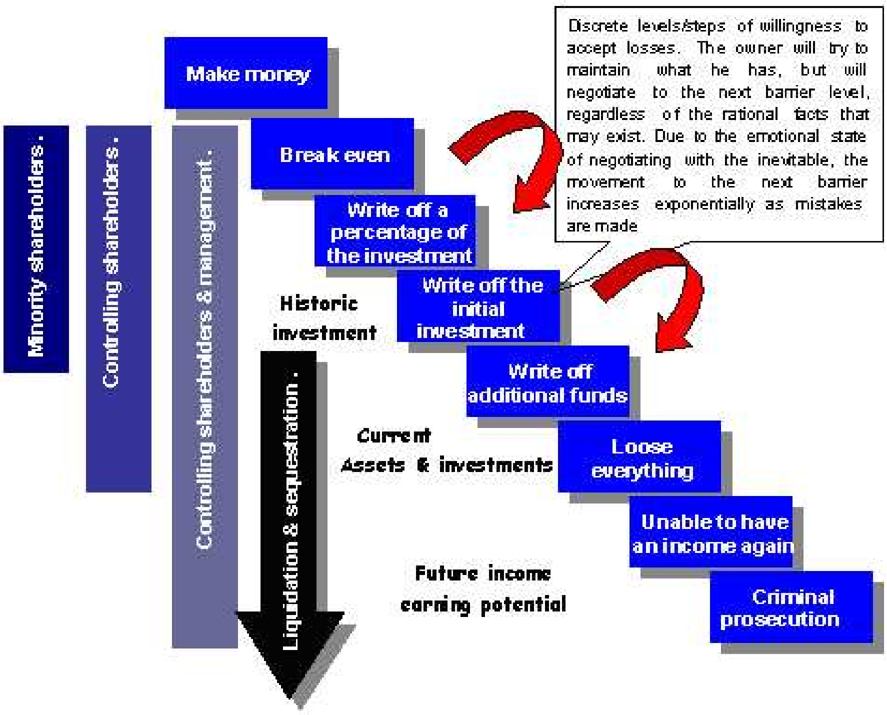
In Europe and the United States, "shareholder activism" has become a common practice to take a crippled company to the next phase during its life cycle, by placing the company in the hands of a "Turnaround professional". It is expected that shareholders will tighten their grip on the business control in South Africa in years to come.

The alternative for a shareholder is to sell his stake in the business, and hope to negotiate a part of the upside that the new owners through the newly appointed management hope to achieve. If this fails to materialise, the alternative is liquidation and the shareholders lose everything.

A shareholders perspective (owner-operated)

An owner-operated business that has gone in to a state of collapse inevitably ends up in liquidation. The reason for this is that an owner is totally emotional about the business decisions. He wants to protect the business and therefore commits all his personal resources to grow the business. The owner has no resources left to find help which leads to the liquidation of the business. The emotional turmoil that the owner finds himself in makes him very irrational, as he vacillates between greed and fear. The individual experiences Denial, Anger, Depression, Negotiation and Acceptance of the situation. The owner should recognize that he has a problem and needs to find expert advice as soon as possible. Should the owner not take these actions he may "trade recklessly" and may be convicted of fraud.

The "stop loss" levels for shareholders



What will the turnaround or restructuring expert do?

When a business goes into decline or collapse it requires leadership (change), not management (maintenance) of the business. The leadership usually does not come from inside the business, but has to come from an outside party. The leader must supply a new insight and energy into the business, while focusing on the staff discipline. The expert must understand the complex interrelationship between the:

- Information Flow - feed back loop of information in relation to events occurring and who, why and how is the information filtered;
- Emotions - the emotional interference of relationships in business decisions by persons inside and outside the business;
- Race against time - and the acceleration in the state of collapse of a business.

There is no substitute for experience and skills when managing a collapsing business and the expert will usually employ the following steps after being appointed:

- Identification and Documentation - Performing a due diligence to determine the state of collapse. This usually has to be done very quickly, to give clear guidance to all the stakeholders involved;
- Devising a plan - a plan to stop the collapse (short term) and ensure a rigorous implementation plan and;
- Setting a strategy - upon completion of the plan, setting a strategy for the business and allowing the business to grow.

The expert may very often constitute a team of legal, financial and other specialists to assist him with the restructure or turnaround of the business.

Requirements for successfully returning a business to profitability

For a successful turnaround or business rescue the following elements must be present to ensure success and may be used by shareholders or a board of directors to determine the outcome of the decision to employ an expert.

- Speed and quality of decisions by the leadership (note not management)
  - Does the leadership understand the crisis that the business is in?
  - Do they have a clear plan with objectives and an exit plan?
  - Does the leadership operate as a cohesive unit, acting decisively and implementing the plan? (i.e. do they inspire confidence)
- The personal skills and relationships of the leadership
  - What experience and qualifications does the leadership have?
  - What is the relationship with the owners and does he report to the board?
  - Who gave the authority (Directors/Management or Shareholders) to take the decisions and implement them?
  - Does the leadership inspire confidence in the shareholders, staff, customers and suppliers?
- Are there sufficient resources:
  - By shareholders, with a commitment of equity to achieve the change in the business?
  - By suppliers and bankers, with a commitment of funding or credit lines to support the change in the business?
  - By staff to co-operate with the leadership to work extra hours or take a reduction in benefits.
- Other conditions that must be considered by the directors or shareholders are:
  - What is the cost of co-operation, and the expectation of entitlement by the staff and suppliers after the business is returned to profitability?
  - What is the exit plan for the business after the turnaround is achieved? (Sale or Management contract must be in place?) Can shareholders trust the same board/management that placed the business at risk in the first place?

- Was the expert contracted to educate the staff and management or was the brief to fix the business?

Conclusion - So who is the sucker at the end of the day?

A business in decline or in a state of collapse is a very serious affair. The systematic economic destruction of value leads to losses for all stakeholders. The question is who can do something about the impending collapse and therefore failing to do something about makes him the "the sucker".

The board of directors – "are the suckers" if they:

- Fail to remain in control of the business. The board should have the tools identify, mitigate and manage risk. Failure to do that leads to the collapse of the business;
- Allow the existing executive management to "fix the business" without consulting an outside expert first;
- If they appoint an expert without considering his qualifications and experience and suitability for the job;
- Do not have direct contact with the expert during turnaround management process; and
- Fail to communicate with shareholders and stakeholders at all times, thereby destroying the confidence with all stakeholders.

The shareholders – "are the suckers" if they

- Fail to manage their investments at all times and replacing boards if the business does not perform;
- Are not able to replace the board with suitable management or turnaround management;
- Not sell their stake in the business and allow the business in liquidation.

The Restructuring or Turnaround Experts – "are the suckers" if they:

- Attempt a restructure or a turnaround without the proper skills, experience and resources;
- Have not procured a proper mandate from a board of directors or the shareholders to report directly to the board or to shareholders;
- Report to the executive management that placed the company in a state of decline or collapse in the first place.

TMA South Africa– "are the suckers" if they:

- Fail to educate directors and shareholders that there are experts that can assist them during difficult periods in a business growth cycle;
- Fail to verify if persons or organisations claim to be experts in the field of restructuring or turnarounds;

To return a company to profitability Restructuring or Turnaround is a highly complex and emotionally draining process. The romantic notion that has been created about the industry results in people underestimating the risk associated with the process. Therefore the advice is "do not try this at home and if you do you are the sucker".

When a business is in distress or in a state of collapse it requires skills and experience that enable the leadership to make informed and decisive decisions quickly. The leader has to inspire, lead and control the business at all times. In essence of any business needs to be run by a management team that is capable of handling any potential or real problem and remain in control at all times.

Identifying the Responsibilities, Actions and when are they the Sucker

Party	Responsibilities	Actions	When are they the "sucker"
Directors	To identify and manage the risk and have full control over the business at all times.	Identify the problem Consult with an expert Inform shareholders Being transparent at all times Appoint the specialist to deal with the problem *Alternatively* Ignore the problem and resign from the board of directors and the worry!	Failing to exercise control means that the business trades recklessly. That may result in criminal charges. Shareholders may decide to start taking action against the directors.
Shareholders	Take an active interest in their investment and assert control over the directors though members meetings.	Appoint new Directors or management to manage the business and be prepared to invest more funds without any immediate results to show for it. Sell their equity stake in the business and hope to negotiate "upside" afterwards. Accept that the business will be placed in liquidation.	Reward directors for bad performance as this will lead to loss (decline) for shareholders. Failing to get rid of a non-performing board leads to a collapse and a total loss.
Owner operators	To identify and manage the risk and have full control over the business at all times.	Identify that the business has a problem and then acknowledge that he is too emotionally involved to make the right decisions for the business. Dealing with emotions and knowing when to stop and allocating more resources to the collapse. Hand over to an expert to handle the business and take a vacation or find an alternative income activity	A high-risk situation as the owner cannot separate personal and business decision leading not only to an investment loss, but it leads usually to a total destruction of personal wealth and family life.
Restructuring expert	Must have extensive skills in balance sheet restructuring and stabilisation plans but does not act as the strategy or business builder.	Deals exclusively with shareholders and may participate on equity gains. Will remove the board and senior management immediately and replace with his own team. Understands that the role is merely a short-term transitional role.	If he commits capital and resources without the experience to do these restructurings. Becomes emotional about the investment or changes his objectives without the necessary resources or mandate.
Turnaround expert	Must have extensive skills and experience in income statement management and stabilisation plans and must set a strategy or be a business builder.	Can deal with shareholders, but is usually appointed by the management of the business. The job may entail refocusing of the business, setting of strategy for business and educating the staff and management in various management methods, such as balance scorecards, etc. Act in a management role with a specific focus or job to be completed.	Management, which caused the collapse, in the first place, appoints an expert who may fix the symptoms but not the illness. The reputation of expert will suffer, as the turnaround would be in vain.
Turnaround or Restructuring Industry (TMA)	Representing the various disciplines in the industry.	To educate and represent the activities of TMA to the public and regulators.	TMA fails to promote the critical role its members play in the life cycle of the business as risk managers.

Suggested Reading:

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Curriculum Vitae of Karl Johannes Gribnitz

Summary of Karl J Gribnitz B Comm, B Comm (Hons) (RAU), M Comm (Unisa)

Managing all forms of risk since the start of his business career, Karl has developed his skills and abilities that enable him to be a valuable arbitrageur, professional director and environmentalist.

As value arbitrageur
Karl is a value arbitrageur, who is willing to make decisions and take risks as a principal. He started Gandalf Trust with Jan Nel in 1994 as merger and acquisition specialists. The basic concept is; the purchase of a business at the perceived value, removing the real and perceived threats and on selling the business. To mitigate the risks associated with this type of business Karl has acquired a specialized knowledge of all aspects on corporate law, JSE Securities Exchange and Securities Regulation Panel rules, accounting matters and corporate finance. Through these activities, Karl became involved in with public companies listed on the JSE and has gained extensive practical experience in corporate governance.

As professional director of public companies
At the age of 40, Karl has served on 13 different boards of companies listed on the JSE. The business activities range from manufacturing, service industry to mining. As Chairman to nine of these boards, he has led various companies to profitability and financial security. Shareholders wealth increased up to one and half thousand percent, after he took control of the companies. Karl has led these companies with a strong strategic focus on delivering wealth for shareholders, while taking all the aspects of modern corporate practice, laws and conventions into consideration.

As non-executive director on the various boards he has been advised on various matters ranging from accounting matters, labour law to strategic initiatives. He has chaired nine audit committees, served and chaired five risk committees and served on three remuneration committees.

As environmentalist
Karl lives on Mirkwood Estate, a property situated 35 km from Pretoria, which forms part of the Klip Kop Conservancy. Karl has been the driving force behind establishing the Klip Kop Conservancy with his neighbours, which won the Green Trust award for the best overall environmental project in South Africa in 2001. The conservancy consists of over a thousand hectares of Bankenveld, which is one of the most endangered bionomes in the world as only 1,38 % of the total area is being protected.