Turnaround Situations

Programme: Managing a Turnaround, Wits Business School, 14 – 18 May 2007

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CEO: Corporate Renewal Solutions

15 May 2007

CRS Turnaround: Turnaround solutions for underperforming and distressed companies

CRS
Corporate Renewal Solutions

Turnaround Situations:

- **What constitutes a turnaround situation?**
- **Business transformation vs. turnaround models**
- **Timeline of financial distress**
  - Management-led correction
  - Informal creditor workout
  - Business rescue
- **How viable are different turnaround situations?**
- **Conclusion**
- **Wrap-up**

What does "turnaround" mean?

"What's in a name?

That which we call a rose by any other name would smell as sweet."

– William Shakespeare

"Ah, Love! could thou and I with Fate conspire

To grasp this sorry Scheme of Things entire!

Would not we shatter it to bits - and then Re-mould it nearer to the Heart's Desire!"

- Omar Khayyam

Turnaround situations vary according to the degree of distress, intervention by creditors, and legal considerations

The Wide Definition:

Stanley J. Goodman

"To produce a noticeable and durable improvement in performance…

to turn around the trend of results from down to up…

from not good enough to clearly better…

from underachieving to acceptable…

from losing to winning."

TMA

- Restoration of corporate value

The Narrow Definition:

Slatter and Lovett

"Firms whose financial performance indicates that the firm will fail…

in the foreseeable future…

unless short-term corrective action is taken."

If there is no danger of failure in the foreseeable future, it is a business transformation ("soft turnaround")

If the firm has already failed, it is a business rescue (turnaround within the legal framework).

Corporate Renewal:

Harlan Platt

- Corporate renewal distinguishes between:
  - Business transformation:
    - Proactive / Preventive
    - Remedial
  - Turnaround
  - Crisis resolution

But these differ for:

- *Creditor intervention (informal creditor workout)*
- *Insolvent turnaround situations (business rescues in terms of insolvency/business rescue legislation)*

A turnaround situation can be defined in terms of the turnaround trigger and role-players involved

Trigger	*Triggered by:*	
Reacting to symptoms of decline or failure	• Very pro-active board or management	
Benevolent shareholders: *)	No	Yes
Reacting to a profit crisis	• Board • Sometimes banks	• Board (late if at all)
Reacting to a liquidity or solvency crisis	• Creditors, mostly banks, before insolvency • Creditors acting in terms of insolvency legislation	• Board (late if at all)

*) Firms with cash-rich holding companies, government departments, State-owned enterprises: no real threat of insolvency

- **Note the timeline: symptoms of decline – profit crisis – liquidity/solvency crisis**
- **In practice a turnaround tends to be triggered too late**

Insolvency:

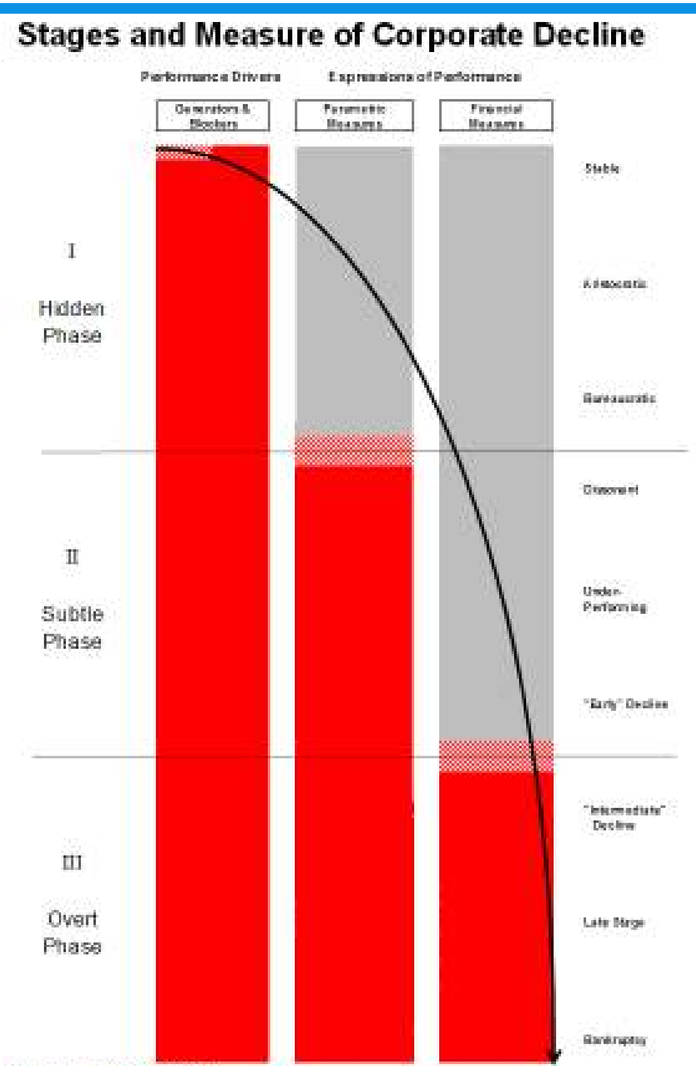
- **Technical: liabilities exceed assets**
- **Commercial: cannot meet creditor commitments i.e. out of cash**

Another way is to define a turnaround situation in terms of the seriousness of the situation

Definition	Financial situation	Management	Systems
Turnaround of underperforming businesses	Underperformance relative to industry standards	Intact	Intact
Turnaround of distressed businesses	Distress	Intact	Intact
Deep turnarounds	Distress	Good managers have left	Broken systems

Deep turnarounds are the most difficult - one probably deals with already insolvent businesses unless it is supported by benevolent shareholders.

A turnaround situation can be defined in terms of the stages of corporate decline



Source: Fitzgerald Associates

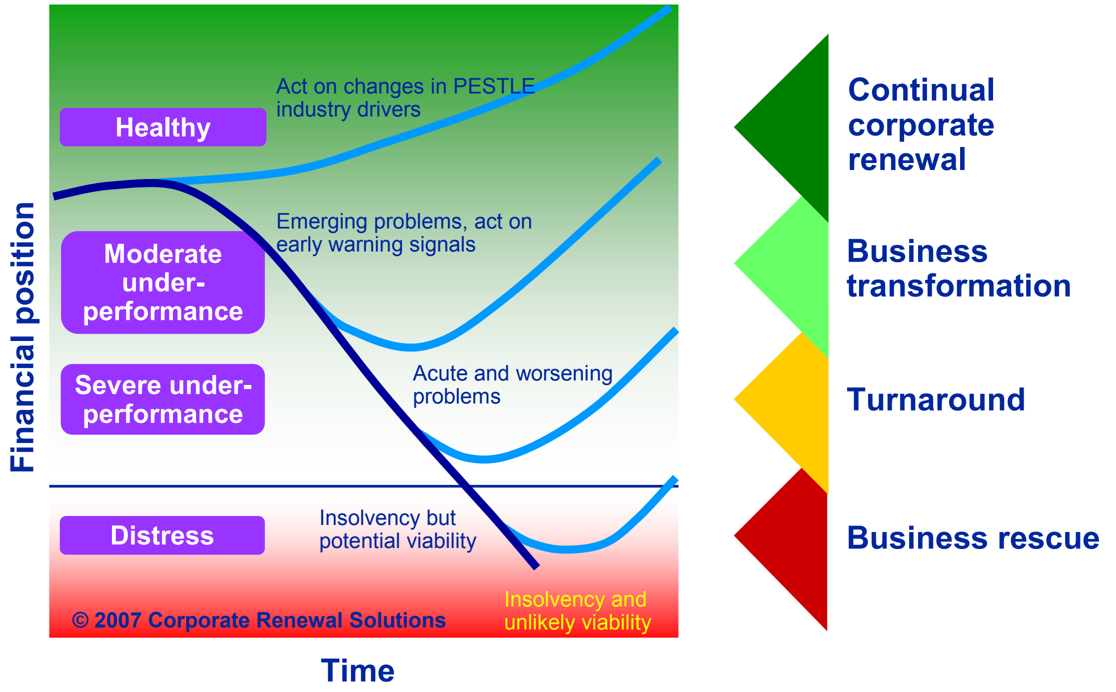
Stage of decline	Description
Phase 1 Decline – the hidden phase	**“Pre-emptive turnaround”**
Phase 2 decline – the subtle phase	**“Business correction”**
Phase 3 decline – the overt phase	**“Classic turnaround”**

Lastly, let’s look at a model based on corporate renewal levels (the CRS model)

Restoration of corporate value:

Corporate health and decline levels:

Corporate renewal levels:



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Although they share a common approach, there are important differences between business transformation and turnaround

Business Transformation Versus Turnaround:

■ Difficult or not applicable in the public sector

	Business Transformation	Turnaround
Problems	Emerging problems, early warning signals of decline	Acute and worsening problems
Situation	Moderate underperformance	Severe underperformance
Crisis	No crisis	Crisis stabilisation, emergency management ■
Funding	Not required	Often required for survival
Management	Leadership alignment and development	Plus management changes ■
Stakeholder management	Internally focused on employees	Also focused on financial and commercial stakeholders
Change management	From the outset	Less so or later in the process
Pace of execution	Measured	Rapid ■
Management style	Participative	Assertive and directive ■

The reframe – restructure – revitalise – renew approach to business transformation

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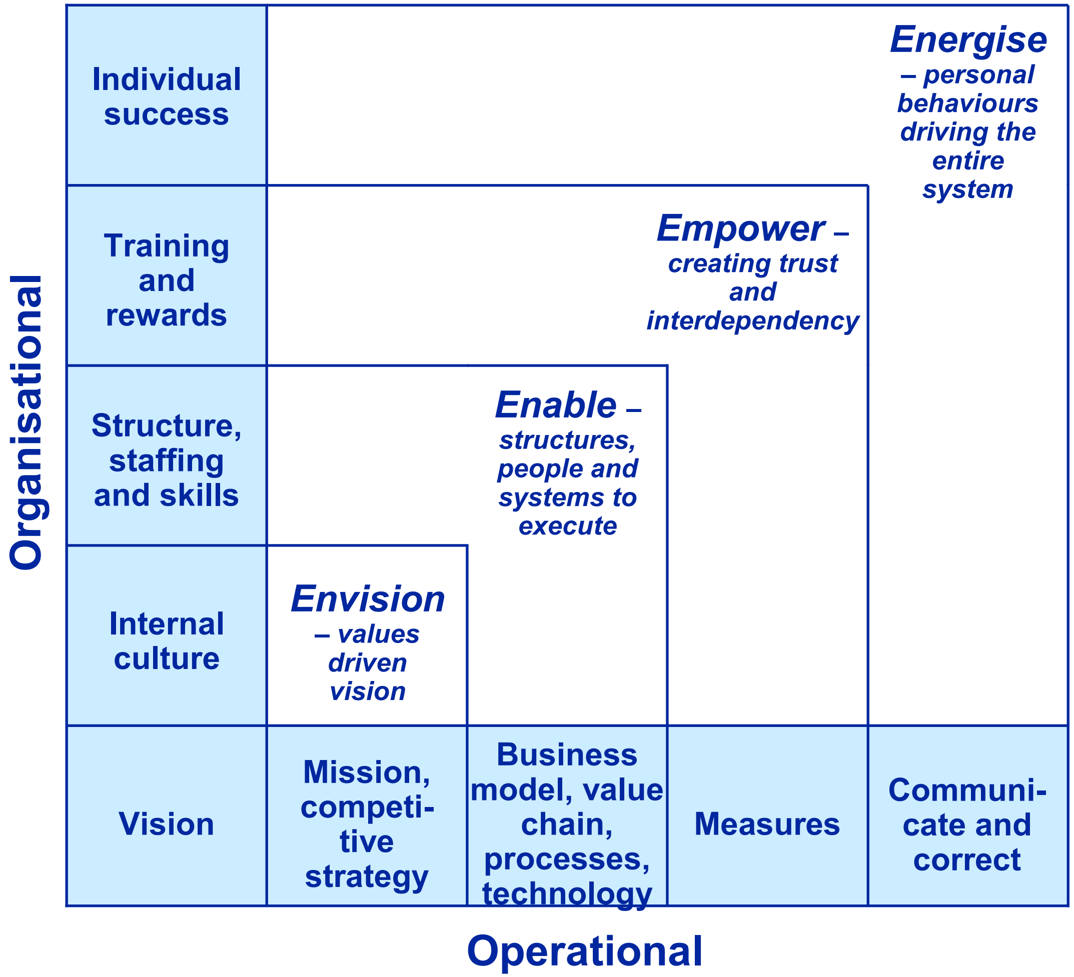
The direction – capability – behaviour – sustainability approach to business transformation

The envision – enable – empower – energise approach to business transformation

The 4-E Framework:



The business case approach to business transformation

Business Case Approach:

Strategic repositioning

- What to be
- Where to go
- Basis of competitive advantage
- Customer value proposition

Reorganisation

- Leadership
- Structure
- Organisational
- Cultural
- Change management

Value chain improvement

- Demand generation (sales & marketing)
- Demand fulfillment (operations)
- Support functions

Revenue enhancement | *Cost reduction* | *Asset reduction*

Impact on:

- Profitability
- Liquidity and cash flow
- Solvency
- Z-Score

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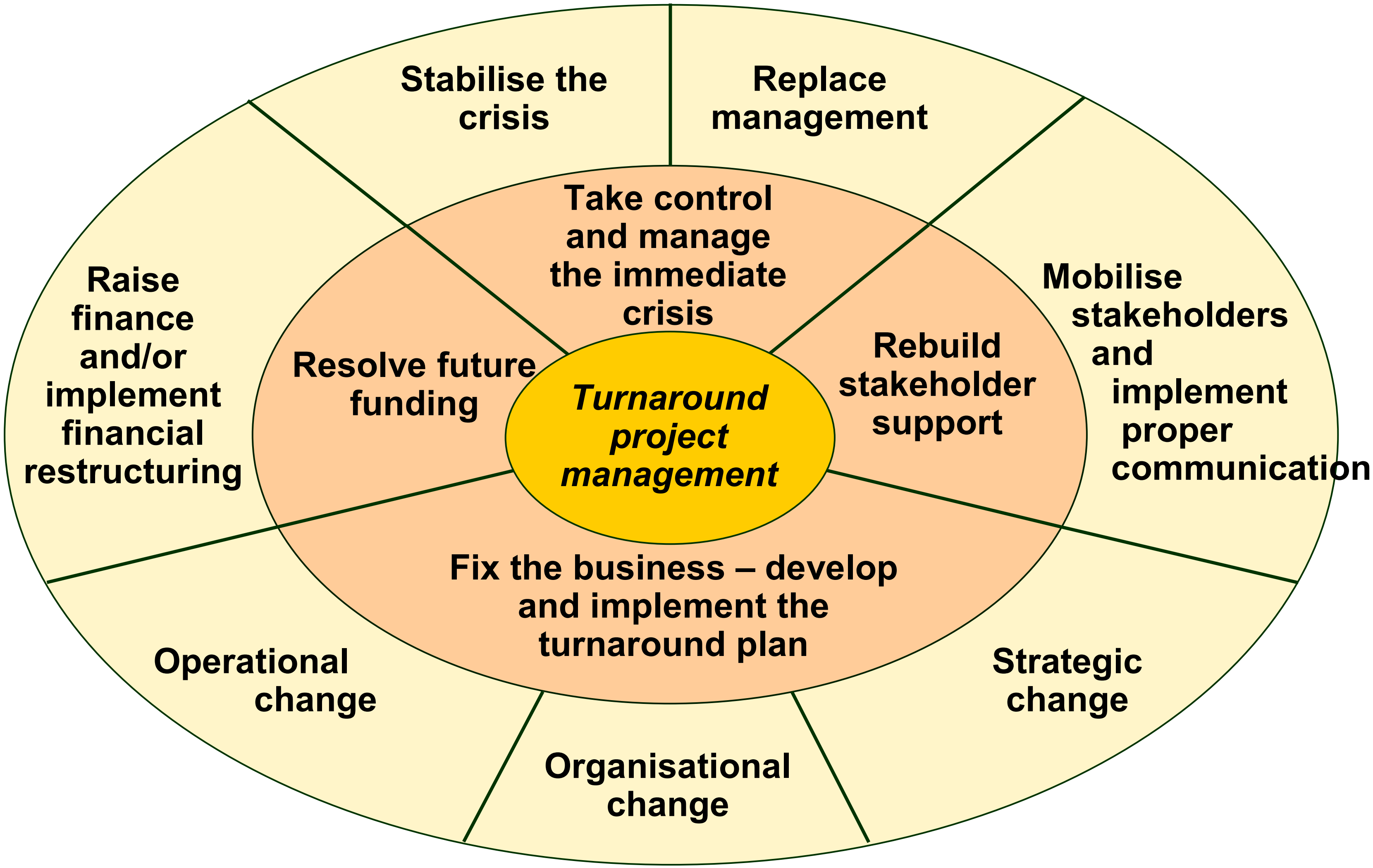
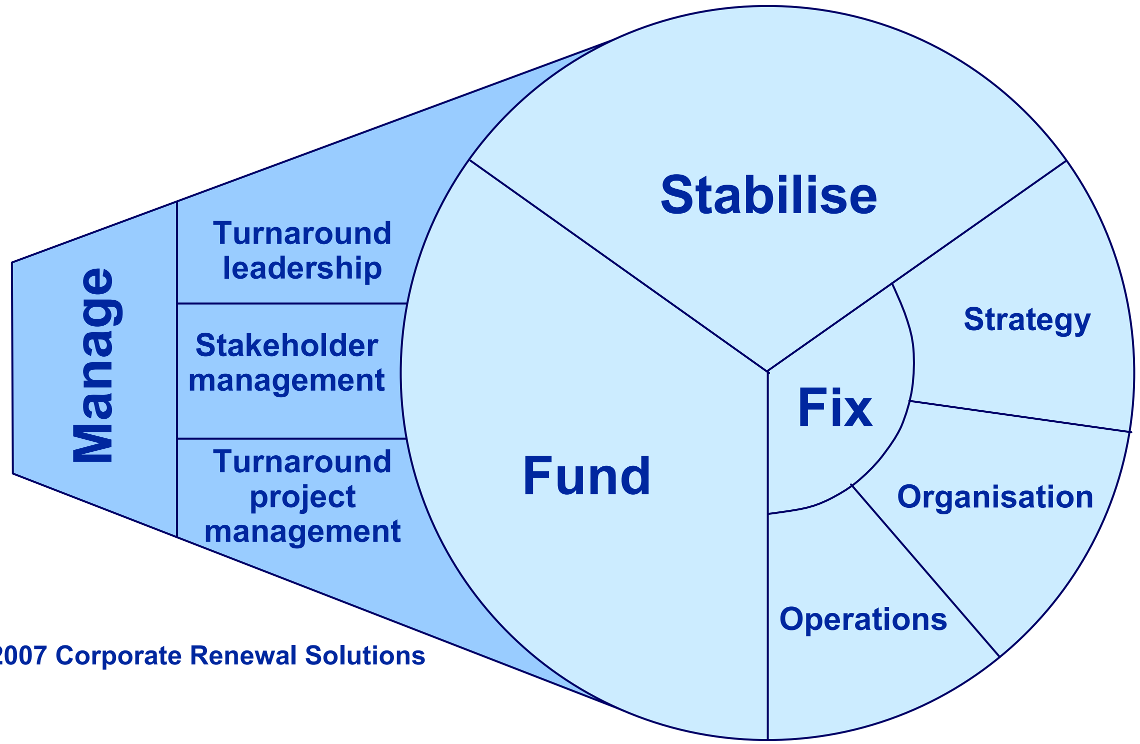
The Slatter & Lovett turnaround model



The CRS turnaround model

CRS Turnaround's strategy components:



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The timeline of financial distress provides a timeline perspective to turnaround situations

The timeline of financial distress provides a framework for:

- **Who is in charge of the turnaround**
- **Direct costs of a turnaround**
  - Management consulting fees
  - Accounting fees
  - Legal fees
- **Indirect costs of a turnaround:**
  - Additional management time
  - Loss of employees, customers and suppliers
- **Success rate of turnaround**
  - Claimholder recovery rate – traditional measure used by insolvency industry
  - Company survival rate – more in the spirit of the new business rescue culture
  - Job retention rate – we would like to see this measure too
- **Legal considerations**

As a troubled business moves along the timeline, costs increase, but the success rate and management power decrease

Business rescue:

- Chapter 6 of the Companies Bill, 2007 to replace Judicial Management (totally ineffective)
- Operational by 2009?

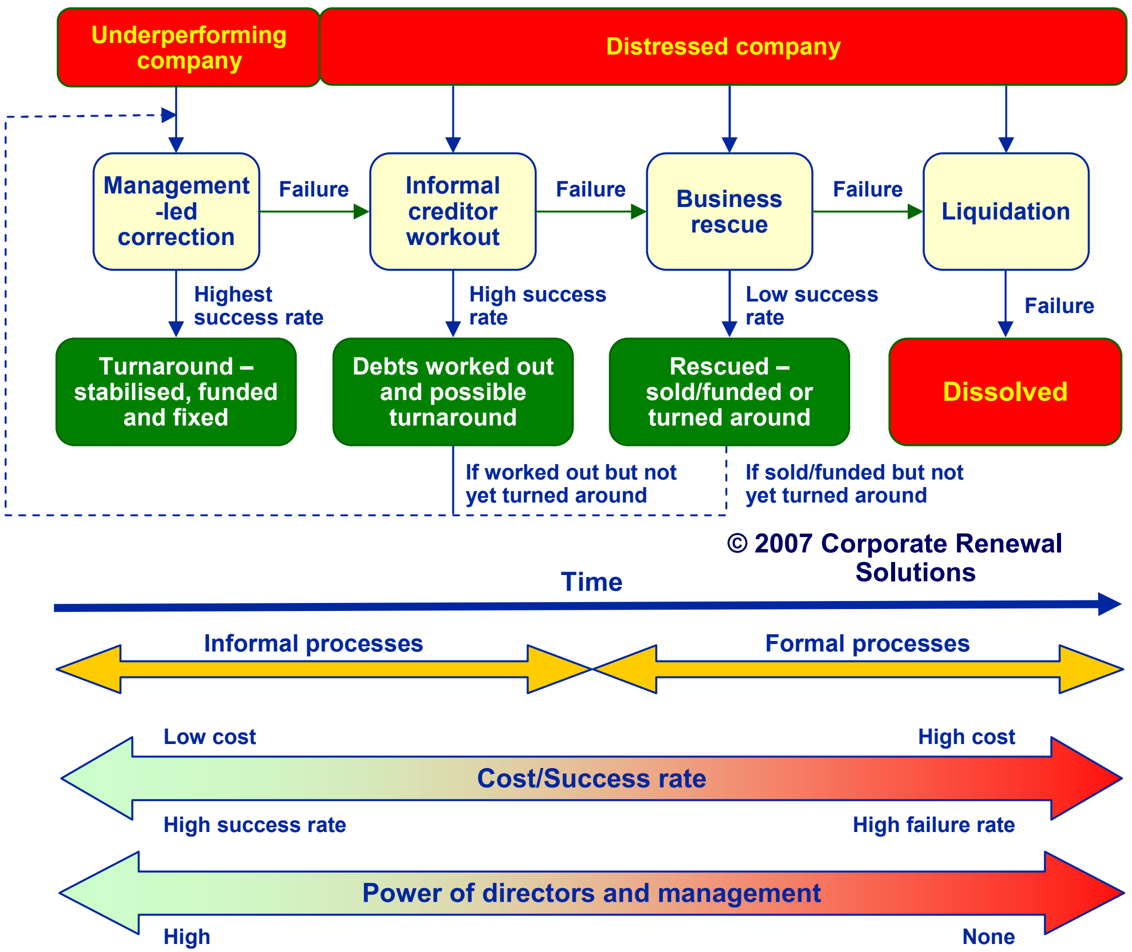
Success rates (UK stats):

- Workout: 75% (Franks & Sussman)
- Business rescue: <47% (Frisby)

UK experience:

New business rescue legislation strengthened informal creditor workout activity

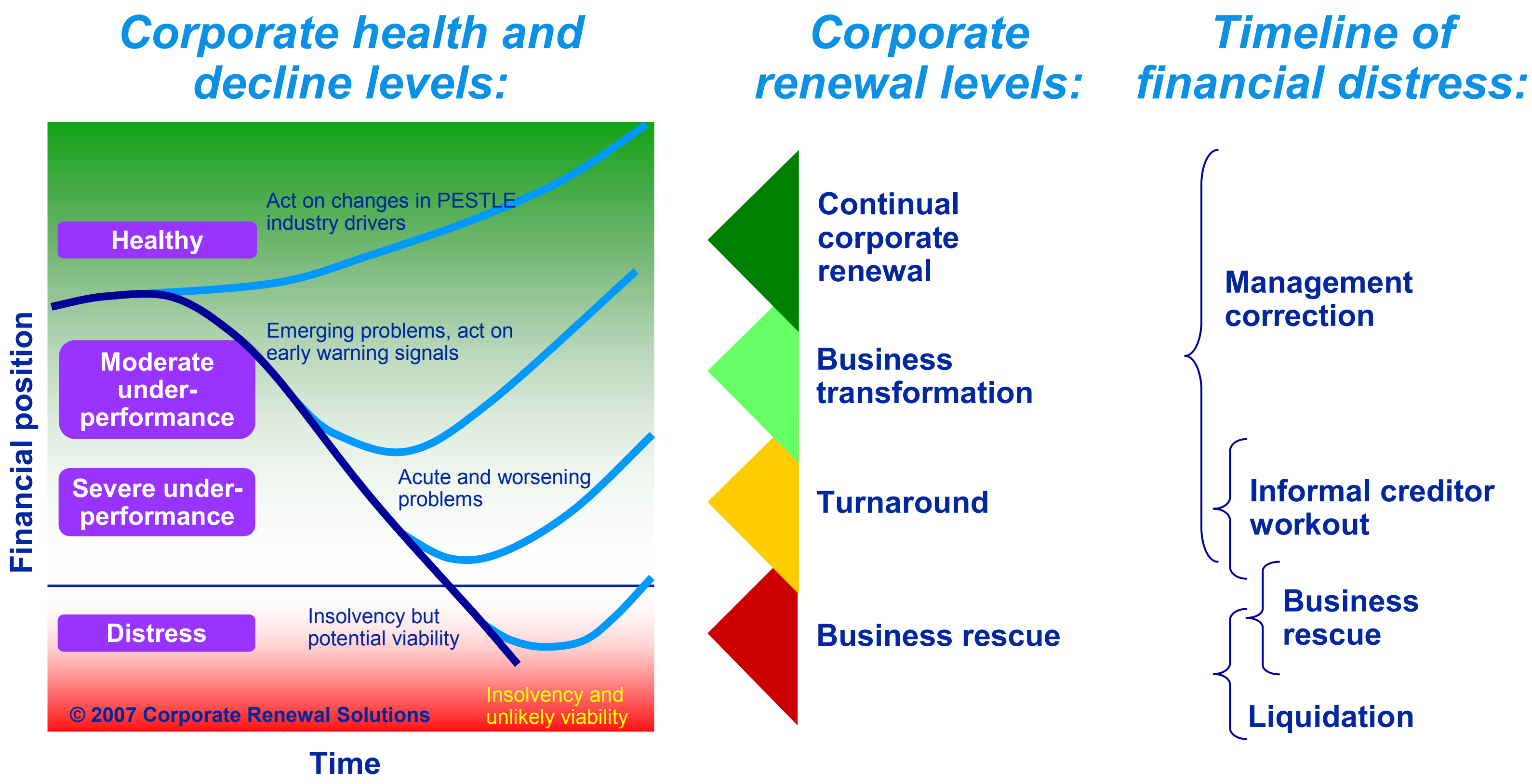
Timeline of financial distress



<table>
<tr><th colspan="6">Timeline of financial distress</th></tr>
<tr><th colspan="3">Informal turnaround processes
(outside of the legal framework provided by the Companies Act and Insolvency Act)</th><th colspan="3">Insolvency processes
(within the legal framework provided by the Companies Act and Insolvency Act)</th></tr>
<tr><td>Emerging problems</td><td colspan="3">Acute and worsening problems</td><td>Insolvency but possible viability</td><td>Insolvency and unlikely viability</td></tr>
<tr><th colspan="2">Management-led correction</th><th>Informal creditor workout</th><th>Business rescue - pre-packaged</th><th>Business rescue - free fall</th><th>Liquidation</th></tr>
<tr><td rowspan="3">Turnaround in the absence of creditor pressure since the financial situation is not yet critical.</td><td rowspan="3">Turnaround when the financial situation is already critical, but in the absence of creditor pressure, due to support from benevolent shareholders. e.g. distressed government organisations, SOEs and companies with financial support from holding companies.</td><td rowspan="3">Turnaround given an informal agreement, between management and creditors (normally banks) to reduce indebtedness.</td><td colspan="2">Turnaround in terms of business rescue legislation as per Chapter 6 of the Companies Bill, 2007.</td><td rowspan="3">No turnaround - realisation of the distressed company's assets and the distribution of proceeds to its creditors.</td></tr>
<tr><td>Present: none</td><td>Present: judicial management and Section 311 Compromise of Creditors</td></tr>
<tr><td>Future: Business rescue proceedings commenced in terms of Chapter 6 of the Companies Bill, 2007 when not insolvent yet.</td><td>Future: Business rescue proceedings commenced in terms of Chapter 6 of the Companies Bill, 2007 once insolvent.</td></tr>
</table>

The timeline of financial distress and corporate renewal levels

Restoration of corporate value:



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Turnaround should ideally occur as management correction

Management-led turnaround:

Where and when

- **Companies where early warning signals of impending distress are recognised early enough and acted upon**
- **Companies that are underperforming but not in financial distress**
- **Distressed companies supported by benevolent shareholders:**
  - Distressed subsidiaries of strong groups which support management-led correction financially
  - Organisations in the public sector

Further characteristics

- **Triggering normally by a concerned Board of Directors**
- **Most turnarounds take place in the form of management correction**
- **Examples:**
  - SA Post Office (Maanda Manyetshe)
  - Edgars (Stephen Ross)
  - Transnet (Maria Ramos)
  - SAA (Khaya Ngqula)
  - Denel (Shaun Liebenberg)
  - Mvuso Msimang (SETA)

Benefits

- **For directors and management:**
  - Directors and management remain in charge of the agenda
- **For creditors:**
  - Action is taken by management to protect the exposure of creditors without the need for creditors to intervene or to invoke a formal insolvency process
- **For all**
  - Highest success rate and the lowest cost of all processes applied to troubled companies

Failure of management to react timeously and successfully to early warning signals of distress normally leads to intervention by creditors.

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Should management-led correction fail, creditors – normally the bank(s) intervene

Informal creditor workout:

Where And When

- **Acute and worsening problems impair a company's ability to meet its commitments to its financial and trade creditors**
- **This normally leads to creditor invention**
- **A workout follows negotiated agreement outside the legal framework i.e. out-of-court settlement on a plan to reduce indebtedness**

Role Of Banks

- **Strong workout capability:**

  "Special portfolio", "credit recovery" or "intensive care" departments in credit or risk management structures
- **Cannot participate in the management or intervene in the affairs of a troubled company, since the rights of other creditors may not be prejudiced**
- **Yet, banks have considerable influence e.g. make continued and/or further support conditional to an independent review of the affairs of a troubled client, and conditional to the submission of credible turnaround plan**
- **In a multi-banked situation a consortium may be formed, which is of great help to make a turnaround work**
- **In a consortium, normally under independent chairmanship, affected banks join forces to:**
  - Ensure a common approach to the problem
  - Ensure that no single lender steps out of line and prejudices the overall situation for the other lenders
  - Sometimes spread the risk

Informal creditor workouts have advantages, but serious disadvantages too

Informal creditor workout (2):

Advantages

- **For directors and management:**
  - Secrecy, avoiding the stigma of a more public formal procedure such as business rescue (and avoiding investigation and challenge of directors' conduct).
  - Cost savings relative to formal business rescue
- **For all:**
  - Flexibility in the absence of legal procedures
- **Success rate (Franks and Sussman study of UK banks):**
  - 75% turned around or switched banks
  - Average time 7,5 months

Disadvantages

- **For directors and management:**
  - Although management remains in charge, the agenda is determined by the terms of the workout agreement
- **For banks:**
  - Degree of "free-riding" by other creditors such as trade creditors and SARS, who offer little by way of solutions, finance and sharing in the risk during the workout, but who share in the benefits should the workout be successful
  - Dissenting creditors, normally the smaller ones, may derail the workout by reverting to formal insolvency laws
  - Have to rely on management's promises, capabilities and integrity to execute a turnaround plan
  - Should a company go into liquidation following an unsuccessful workout, banks run the risk of being accused of having favoured themselves during the workout
  - Banks are often blamed if job losses occur as a result of the workout

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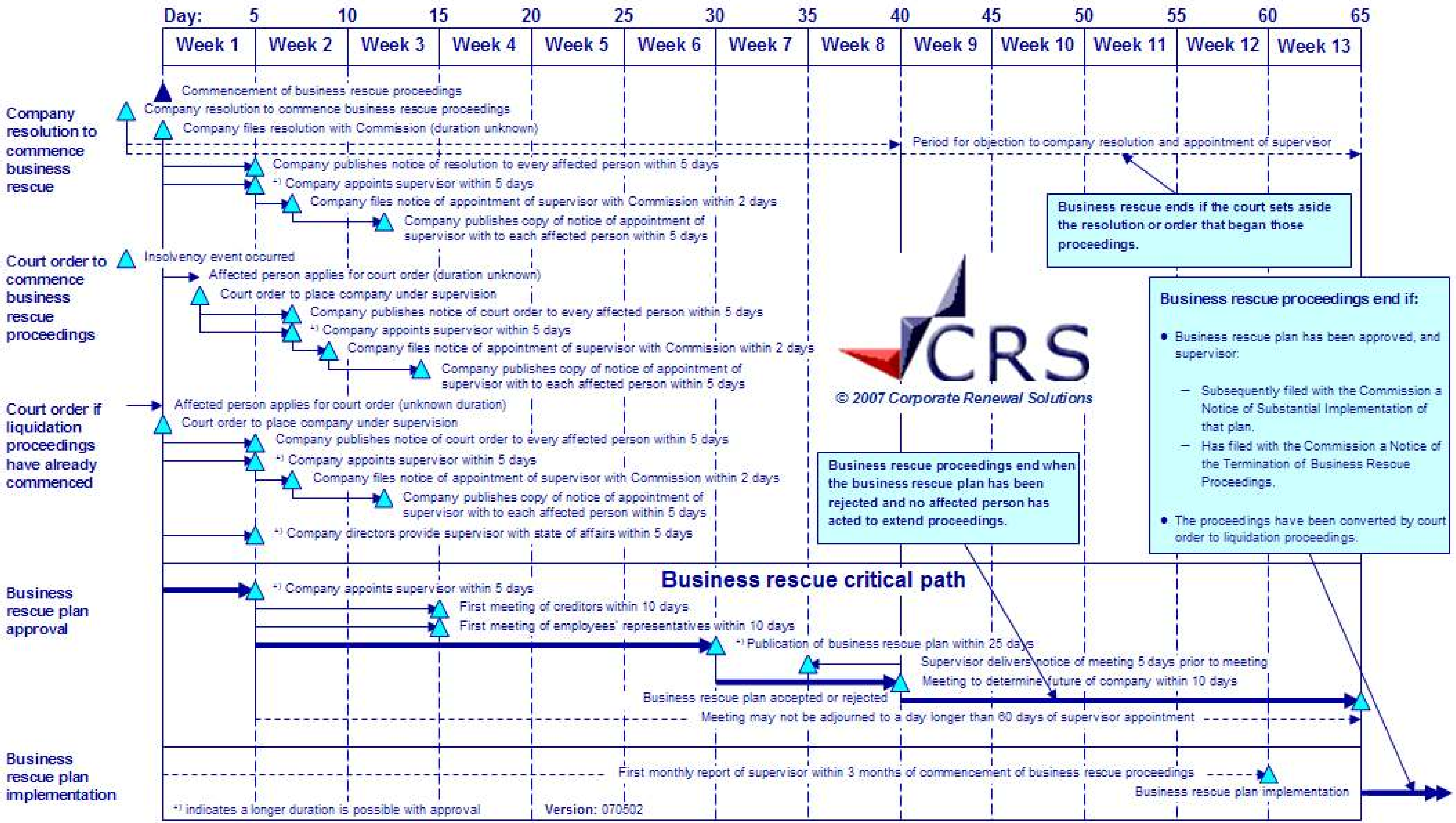
Business rescue timeline



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It can take 65 days or longer for the business rescue plan to be accepted or rejected

For more information see www.turnaround-sa.com

Business Rescue Process Critical Path:

Conditions applying:
- Temporary moratorium on the rights of claimants against the company or in respect of property in its possession
- Suppliers to supply under same terms and conditions as before
- Company can suspend contracts; Post-commencement finance

Commencement:
1. Company resolution filed with Commission
2. Affected person applies for court order (critical path is longer than indicated below by the duration of getting court order)
3. Court order granted to place company, against which liquidation proceedings have begun, under supervision

Appoint supervisor	Publish business rescue plan	Meeting to determine future of the company	Approve/reject business rescue plan	Business rescue
5 days	25 days	10 days	25 days	

60 days (3 months) cut-off to approve business rescue plan

65 days (+ duration of getting court order in case of 2.)

10 days — 1st meetings of creditors and employees' representatives

- *Timelines reasonable*
- *No explicit mention of emergency management as a supervisor role – crisis stabilisation should commence immediately!*

Company publishes:
- Notice of resolution/court order to affected persons
- Notice of appointment of supervisor with Commission
- Copy of notice of appointment of supervisor to affected persons

Days: 5 2 5

Termination:
a. Court sets aside resolution
b. Business rescue plan rejected and no affected person act to extend
c. and d. Supervisor files Notice of Substantial Implementation or Notice of Termination of Business Rescue Proceedings
e. Conversion by court order to liquidation proceedings

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Pre-packaged business rescue is preferable to freefall business rescue

Pre-packaged vs. free fall business rescue:

Informal	*Formal*
• Devise business rescue plan • Negotiate with major affected persons	Formal business rescue process © 2007 Corporate Renewal Solutions 65 days (+ duration of getting court order in case of 2.)

Pre-packaged business rescue:

- Pre-packaged solution before insolvency sets in, when still in cash and / or with borrowing capacity:
  - Devise business rescue plan
  - Negotiate with major affected persons
  - Place company under supervision to gain legal protection and benefits
- Higher success rate, shorter formal process, higher claimholder recovery rate, lower cost

Free-fall business rescue:

- Method of last resort, mostly dead on arrival
- Out of cash and borrowing capacity
- High chance of ending up in liquidation, except that now:
  - Supervisor fees are an additional cost
  - Action can be taken against past wrong-doing
  - Employees are better off
  - Secured and unsecured creditors are worse off

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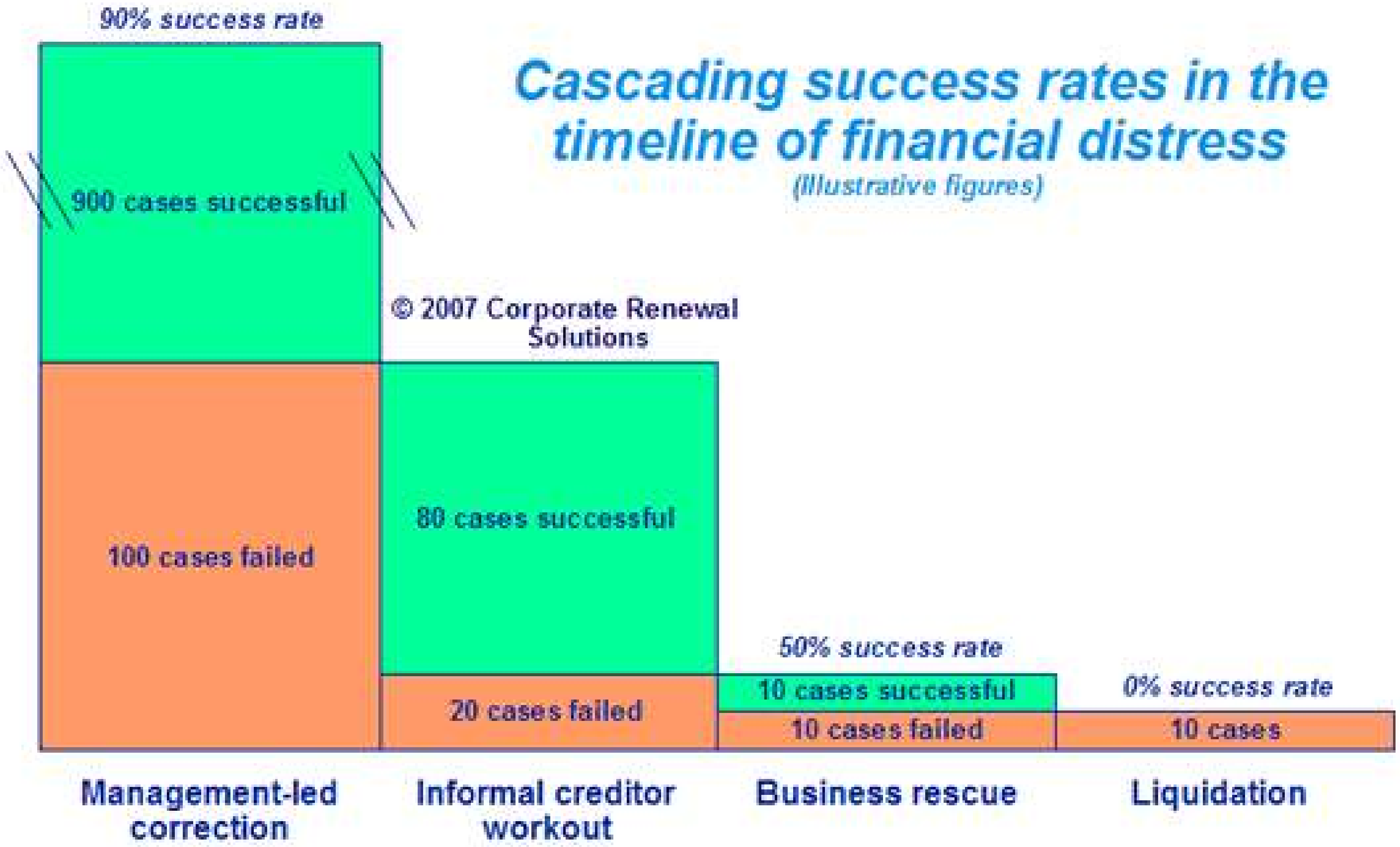
The timeline of financial distress waterfall

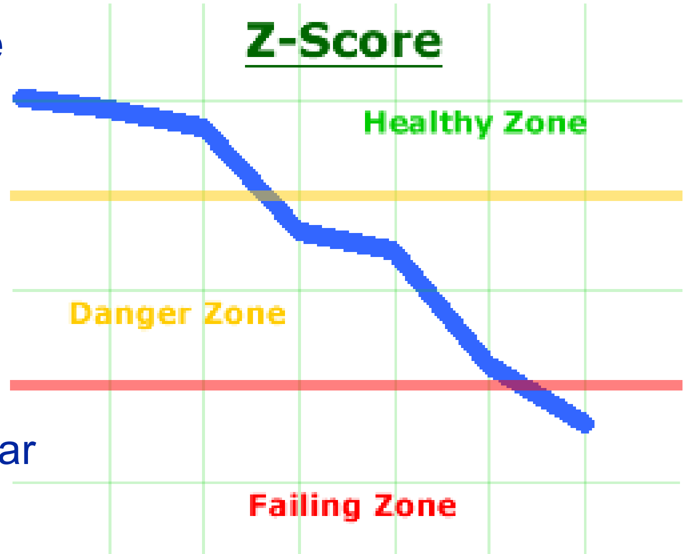


The earlier a turnaround starts, the higher the success rate.

The financial health of a business can be accurately determined for any turnaround situation

Z-Score:

- **The Z-Score applies statistical techniques (Multiple Discriminant Analysis) to financial ratios (profitability, solvency, liquidity, etc.) to determine the overall health status of a business:**
  - Healthy Zone: Business is in good shape
  - Danger Zone (zone of ignorance, zone of uncertainty): Warning signals, exercise caution
  - Failing Zone: High likelihood of bankruptcy within one year
- **Thoroughly tested and broadly accepted distress-prediction model**
- **Developed by Professor Edward I. Altman of the Stern School of Business at New York State University:**
  - Active participant in the Turnaround Management Association
  - Chairs the association's Academic Advisory Council



Note that there is are Z^1, Z^2 and Z^3 Scores depending on listed vs. unlisted, and manufacturing vs. non-manufacturing.

The most daunting task faced by turnaround practitioners is turnarounds that are triggered to late

- **Turnaround action should ideally commence when the Z-Score starts declining, at the latest when a company enters the Danger Zone**
- **In practice, however, turnarounds:**
  - Suffer from late starts, or
  - They take too long before taking the shape of a serious turnaround intervention
- **Once in the Failing Zone, the business is, in the absence of turnaround action, likely to be insolvent (a business rescue case) within a year (95% probability)**
- **This situation presents turnaround practitioners with the most difficult scenario possible - that of the "deep turnaround":**
  - Banks will not lend
  - Difficult, if not impossible to find private equity funding
  - Suppliers stop supplying, tighten up on credit terms and/or ask for upfront payment
  - Key clients will not buy or hedge their bets by shifting their purchases to more stable competitors
  - Key staff are long gone to better situations or preparing to move

How to determine turnaround viability using the Z-Score

- **Prepare the turnaround plan**
- **5-year financial forecast based on turnaround plan:**
  - Income statement
  - Cash flow statement
  - Balance sheet
- **Calculate the applicable Z-Score going forward**
- **Your are unlikely to get stakeholder support for your turnaround plan unless:**
  - You are out of the Failing Zone within a year, perhaps two years
  - You are in the Healthy Zone soon thereafter

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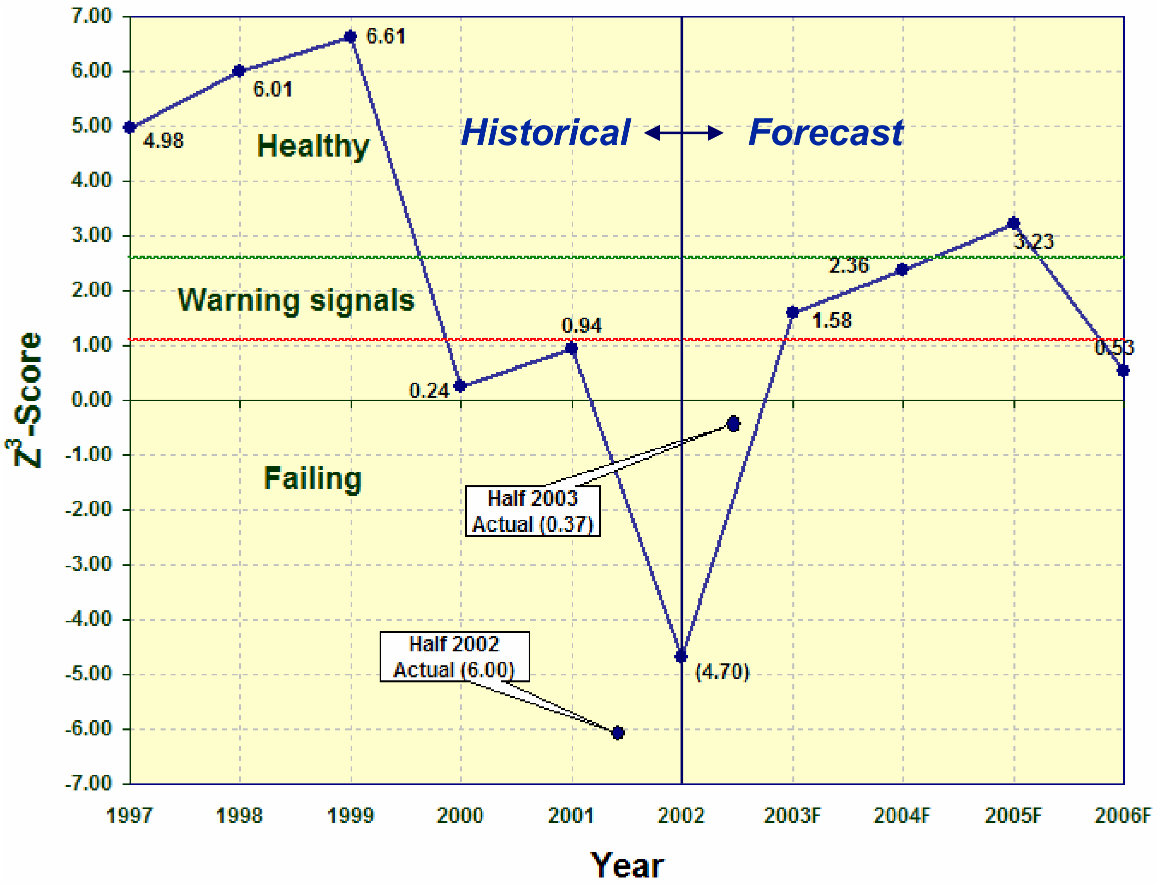
Let's look at an example of how the Z-Score was used to forecast turnaround results at a listed distressed company



A business in the Failing Zone has a 95% chance of formal bankruptcy within a year, but can be turned around.

- **Z-Score graph reflects history, and turnaround plan inclusive of debt repayment schedule agreed with bank (informal creditor workout)**
- **Share price was R0-35 at the start of the turnaround**
- **Turnaround plan soon thereafter attracted R20m private equity investment (not reflected in Z-Score) at R1-20/share**
- **Share price increased to R2-00 within months**
- **Company adhered to bank debt repayment schedule**
- **Post-turnaround: forecast problems realised, share price has dropped**
- **Today: bottom 5% of its sector on stock exchange**

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Conclusion

"It is far easier to tread on an acorn than on an oak tree" – Neil Harvey.

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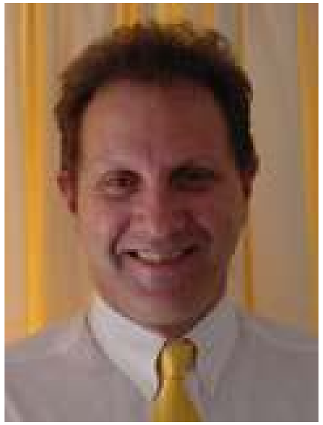
Questions?



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CEO: Corporate Renewal Solutions

Corporate Renewal Solutions is a black empowered management consulting firm specialising in business transformation of underperforming companies, and turnaround / business rescue of distressed companies

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Resume of Jan van der Walt

- **As CEO of Corporate Renewal Solutions, Jan van der Walt has 26 years' experience in corporate renewal, ranging from management consulting to business transformation to turnaround management and business rescue**
- **In his career he served as both senior accountable executive and in advisory positions in numerous turnaround and crisis management situations in a variety of industries ranging from the public sector to private sector clients as large as R5bn turnover**
- **He has wide experience in devising and implementing leadership, strategy, financial, organisational and operational solutions in business transformation and turnaround projects**
- **Jan is an active participant in business transformation and turnaround management conferences, publishing turnaround articles and business school guest lecturing**
- **He played a leading role in the formation of TMA-SA (Turnaround Management Association - Southern Africa) and ABASA (Association of Business Administrators of South Africa), where he serves on the boards and executive management of both organisations**
- **Jan was the main TMA-SA author of submissions to the Department of Trade & Industry and National Treasury on how government can assist with turnarounds, and to the dti on new business rescue legislation**
- **Qualifications:**
  - MBA (Stanford Business School), where he studied with a Fulbright Scholarship and specialised in strategy
  - Honours B.Sc. in Operations Research (University of South Africa)
  - B.Sc. Industrial Engineering degree (cum laude) (University of Pretoria)
- **Personal web page: www.turnaround-sa.com/team/jan van der walt.asp**