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Time to fix the business, not just the balance sheet

| BY ALAN TILLEY

Since interest rates fell to 0.5 percent after the Lehman Brothers crisis in 2008 overleveraged and troubled businesses were gifted a lifeline; time to survive on low debt service costs whilst adjustments were made to rectify the underlying business. Banks with enormous structural problems, not to mention political problems, were reluctant to force companies in covenant breach into administration. Various ways were found to avoid putting companies into the bankruptcy process. Debts were rescheduled or extended in order to avoid testing asset values in a depressed market which would have probably provoked even bigger losses than their balance sheet reserves could absorb.

In this era of 'extend and pretend' formal administrations and bankruptcies fell to the lowest level in several years. 2010 bankruptcies were 30 percent down on 2009 leaving restructuring professionals unexpectedly short of work. In contrast, bank workout groups expanded enormously to manage the considerable number of potential business causalities in 'suspended animation'. Professionals looked to increasing interest rates and higher debt service costs to push companies over the edge. Creditor groups looked to a return to better economic growth to improve potential asset recovery levels. As data comes in for first quarter 2011, both will be disappointed. Growth is subdued and interest rates look set to be on hold throughout the remainder of the year. There does not seem to be an upturn in the restructuring business on the immediate horizon.

In stark contrast is the process emerging across the Irish Sea where NAMA, the so called government 'bad bank' tasked with buying risky commercial loans from Ireland's debt laden banks, has taken a more aggressive attitude to recovery. With interest rates dictated by unsympathetic European institutions the cost of 'wait and see' is higher. Some trophy London property asset prices are also improving, certainly in relation to Irish asset prices. The arithmetic favours short term action. At some point this will occur in the UK too.

Overleveraged companies should be preparing for this now and vigorously challenging their business models, adjusting them to more straightened times. Whilst many companies are doing this there is some evidence that this process has not been pursued aggressively enough by others. At the outset of the recession some companies, particularly in the sectors most vulnerable to the downturn such as retail, were seeking relief of onerous leverage or legacy costs by resorting to CVAs or prepacks. Laudable as this was, a view not always shared by affected creditors, evidence is unfolding that insufficient action was taken to change management attitudes and cut deeper. In the retail sector we have seen CVAs at JD Sports, Oddbins and lately Focus reappear on the restructuring horizon, either as revamped CVAs or full administrations.

Whilst it is simplistic to say that more aggressive action to change the business and not just restructure the debt would have altered the outcome, there is an underlying issue. In restructuring businesses through consensual or near consensual arrangements existing management have a greater influence on the outcome than in an administration and creditors do not always exert sufficient influence on management change as a condition of concessions. Accordingly, insufficient change to the underlying business can occur and an opportunity to significantly change direction for the better is missed. In extremis this can lead to only deferring and not preventing eventual demise.

This may seem like a vote for administration and insolvency over consensual change, but it is not. On balance the loss of enterprise value in an insolvency process is greater than the risk that business plans are not aggressive enough in consensual restructuring. What needs to be addressed by restructuring professionals is to pay more attention to operational issues and management change. In a period where economic recovery appears to be anaemic at best, just restructuring balance sheet debt is insufficient; akin to 'reorganising the deckchairs on the Titanic'. A more thorough appraisal of business plans by professionals with operational experience who can dig deep into the culture of a company is necessary.

Will this occur? I am not overly optimistic. Restructuring in the UK is dominated by financial professionals rather than genuine turnaround professionals and as capable as they are and imaginative in achieving financial solutions, their lack of 'hands on' experience in running a business makes it difficult to force issues of management change, particularly as change may affect the very people who have appointed them to the assignment. Of course, this latter constraint applies equally to seasoned operational turnaround consultants, many of whom have been disappointed at the degree of management change they were able to influence on some clients during the turnaround process. However, in fighting the fight and engaging all stakeholders to work for that mythical 'optimum solution', having real experience can help move the end result to a business plan with operating performance more capable of servicing the restructured balance sheet, even at interest rates higher ▸▸

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than forecast and economic activity lower than forecast.

Over the past few years significant changes in restructuring processes have been made and the experience post 2008 is greatly improved from the 'slash and burn' era that followed the recession of the early 1990s. Professionals and legislators can take great credit from these improvements that have been beneficial to preserving enterprise value, employment levels and to society in general. However, there is scope for more progress to be made in getting beneath the surface of the business and encouraging all stakeholders to be more challenging of business plans and management direction. Turnaround management as distinct from financial restructuring has an important role to play. This downturn has some time to run. A rapid bounce back of business demand is not going to come to the rescue of many businesses. More robust operational solutions are required.

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