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SPECIAL REPORT: DISTRESSED M&A AND INVESTING

Zombies need not be zombies

by Alan Tilley and David Bryan

Much publicity has been given to so-called zombie companies; companies in 'suspended animation' struggling to stay alive in a difficult market place, over leveraged, with limited liquidity and with no access to finance, their existence dependent on continuing low interest rates and compliant bankers and creditors. There has been reluctance by banks and other creditors to trigger an insolvency event mindful of having to record a loss in what is becoming increasingly recognised as a value destructive process. Having cut overheads to the bone and without the cash flow to fund investment in products, new markets or more efficient processes the zombies are losing competitive ground and increasingly exposed to a loss of a significant customer or an increase in interest rates. Having spent months in survival mode management have been detracted from positioning for growth and shorn of the resources to fund it. They are often in denial. Their companies are living on borrowed time and surviving on creditors' forbearance.

Critics of the creditors' reluctance to foreclose, or 'extend and pretend' as it has become known, claim this to be a wasteful use of scarce capital and that the short sharp shock of insolvency where the strong absorb the weak will benefit UK economic recovery. Others contend that destroying goodwill, particularly in human capital, is counterproductive and that the knock on effect of losses to creditors, both financial and trade, is detrimental to economic recovery. They can't both be right so what can be done to release the latent energy in stressed out companies whilst deleveraging balance sheets and protecting creditors without tipping the economy back into recession?

A study last year for R3, the UK Insolvency Industry's main professional body, put the number of companies near to insolvency at close to 146,000, an enormous number. It is useful to analyse this number in more depth. Probably 75 percent fall into one of the following four categories, targets for specific remedy: (i) bad companies with bad balance sheets that should be restructured in insolvency; (ii) good companies with bad management and bad balance sheets that attract distressed investors who can provide capital and new management; (iii) property companies with tangible assets where the value is determined by an open market albeit constrained by planning regulations – it is difficult to turn around a property company, maybe press for change of use but otherwise wait for the market to improve; (iv) and retail companies with expensive leasehold obligations that have reacted slowly to the structural changes driven by online purchasing – the extent of their obligations and the constraints of English leasehold law on distressed retail companies are such that formal process is usually necessary to arrive at a solution.

This leaves an army of average companies with average management but with bad balance sheets requiring another approach to escape from inertia.

It is this group of companies, mainly in manufacturing, distribution or service industries that restructuring professionals can help. There is a range of tools at their disposal from strategic analysis, profit improvement, consensual balance sheet deleveraging, new equity introduction, CVAs and, in extremis, pre-pack insolvencies. It is this group of companies where action needs to be taken to release the animal spirits of entrepreneurial management that will get the UK economy back on track.

The challenge is to get the professionals through the door and into a position where they can guide management to an appropriate solution; where the operation can be repositioned for growth and the balance sheet restructured and serviced from resulting improved operational cash flows. There is no shortage of professional advisers who can guide this process. There has just been a shortage of crisis triggers to force management and shareholders to seek help.

Given the range of solutions and the professional resources available it could be argued that their zombie status is optional. Removing the zombie mantle is in the hands of shareholders who are often either management or shareholders who have become too remote from management and the decision making process. Critically, it is in the self interest of these parties to act, as failure to act will erode corporate competiveness and through business failure and insolvency they will either lose their jobs or the value of their equity.

However, there does appear to be some recent recognition of a need for positive action in the marketplace and a slow and growing change of attitude. Whereas since Lehman Brothers collapsed the emphasis has been on balance sheet restructuring, with little creditor pressure for management and operational change, professionals report a small upturn in demand for operational improvement as a precursor to balance sheet renegotiation. And whereas over the past three years banks have felt constrained in aggressively pushing the appointment of advisers to guide operational and management change, their leverage is strengthening in line with the improved strength of their own balance sheets. Encouraging appointment of professional advisers will only enhance their level of recovery.

And as the economic outlook is stabilising with embryonic indicators of – albeit anaemic – growth it does give management an opportunity to plan ahead with more confidence. Presenting a business plan based on an objective strategic review with a plausible financial plan, based on competitive products and services, and with sustainable investment in product and new market development, will ensure a better reception from creditors or potential investors to restructuring of debt, and accordingly a more favourable outcome.

Restructuring professionals bring expertise, independence, originality and credibility to this process and benefits that outweigh the cost. They can advise on the strength of leverage in seeking a balanced solution for all stakeholders; whether that is a debt-to-equity swap, deferred payment terms, a haircut, potential new investors or a combination of these solutions. They can advise from a range of options in their toolbox; operational improvement, management reorganisation, business and financial plan presentation and negotiation skills. They can give guidance on negotiation tactics; whether to restructure consensually or through a Creditors' Voluntary Arrangement for example. There are as many options as there are situations. There is scope in the market for struggling companies to take it upon themselves with professional help to plan for a more profitable future. There is scope for all stakeholders to seek a solution that maximises value preservation in restructuring. Zombies need not be zombies. In any event they cannot be in suspended animation forever. They must change or die. Their future is in their own hands.

Alan Tilley and David Bryan are principals at Bryan Mansell & Tilley LLP. Mr Tilley can be contacted on +44 (0)1865 858 738 or by email: atilley@bmandt.eu. Mr Bryan can be contacted on +44 (0)20 3178 4902 or by email: dbryan@bmandt.eu.