By Ivan Uttley

# A Snap shot on Business Rescue in South Africa and the continued importance of informal loan workouts and the necessity of investing in remedial, turnaround, and negotiated compromises before entering business rescue.

**"If I had asked people what they wanted, they would have said faster horses." – Henry Ford**

There has been a lot of bad press about Business Rescue, and its effectiveness. Is there any merit in what is being claimed?

http://www.entrepreneurmag.co.za/advice/business-leadership/risk-management/sos-for-business-rescue/

http://www.bdlive.co.za/business/2014/08/06/business-rescue-under-scrutiny-as-remedies-fail-to-save-stricken-firms

Perhaps unfair, certainly not balanced, so let's try and be objective

We'll assess work done by the world bank in looking at insolvency, the legislation and the outcomes in South Africa compared to those of countries in the OECD.

We start with the "Ease of doing business" measures, in which Business Insolvency and Rescue are considered.

Then we look at Business Rescue and the associated insolvency laws.

# What obstacles do SMEs need to navigate and with what ease?



| Topics | DB 2016 Rank | DB 2015 Rank | Change in Rank |
|---|---|---|---|
| Starting a Business | 120 | 113 | -7 |
| Dealing with Construction Permits | 90 | 82 | -8 |
| Getting Electricity | 168 | 168 | No change |
| Registering Property | 101 | 97 | -4 |
| Getting Credit | 59 | 52 | -7 |
| Protecting Minority Investors | 14 | 12 | -2 |
| Paying Taxes | 20 | 19 | -1 |
| Trading Across Borders | 130 | 130 | No change |
| Enforcing Contracts | 119 | 117 | -2 |
| Resolving Insolvency | 41 | 38 | -3 |
| Weighted Average | 73 | 69 | -4 |

Relative to the rest of the world, the republic continues to be a difficult place for SMEs

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Source: http://www.doingbusiness.org/data/exploreeconomies/south-africa

# Resolving Insolvency – its components.



| Indicator | South Africa | Sub-Saharan Africa | OECD |
|---|---|---|---|
| Recovery rate (cents on the dollar)<br>The recovery rate calculates how many cents on the dollar secured creditors recover from an insolvent firm at the end of insolvency proceedings. | 35.3 | 20.0 | 72.3 |
| Time (years)<br>The average duration of insolvency proceedings. The time of the proceedings is recorded in calendar years and includes all appeals and delays. | 2.0 | 3.0 | 1.7 |
| Cost (% of estate)<br>The average cost of insolvency proceedings. The cost of the proceedings is recorded as a percentage of the estate's value.(lawyers, court, auction, administrators & depreciation) | 18.0 | 23.1 | 9.0 |
| Outcome (0 as piecemeal sale and 1 as going concern)<br>In the case study run, what would the outcome of the rescue be? 1 = success going concern | 0 | 0 | 1 |
| Strength of insolvency framework index (0-16)<br>The index is the sum of four component indices: commencement of proceedings index, management of debtor's assets index, reorganization proceedings index and creditor participation index. | 14.5 | 6.3 | 12.1 |
| Resolving Insolvency (ranking in the world) (50% Recovery rate, 50% Framework) | 41 | 38 | -3 |

Source: http://www.doingbusiness.org/data/exploreeconomies/south-africa#resolving-insolvency

# Resolving Insolvency.



| Insolvency Framework - Attributes | South Africa | Sub-Saharan Africa | OECD |
|---|---|---|---|
| Strength of insolvency framework index (scoring 0-16)<br>The index is the sum of four component indices: commencement of proceedings index, management of debtor's assets index, reorganization proceedings index and creditor participation index. | 14.5 | 6.3 | 12.1 |
| Commencement of proceedings index (scoring 0-3)<br>The index measures what type of proceedings (liquidation, reorganization or both) debtors and creditors can initiate and what standard is used to declare a debtor insolvent. | 3.0 | 2.2 | 2.8 |
| Management of debtor's assets index (scoring 0-6))<br>The index tests provisions on continuation and rejection of contracts during insolvency, avoidance of preferential and undervalued transactions and post-commencement credit. | 6.0 | 4.1 | 5.3 |
| Reorganization proceedings index (scoring 0-3)<br>The index measures whether and how creditors vote on a reorganization plan and what protections are available to dissenting creditors. | 2.5 | 0.4 | 1.7 |
| Creditor participation index (scoring 0-4)<br>The index tests creditors' participation in and their rights during liquidation and reorganization proceedings. | 3.0 | 1.1 | 2.2 |

Relative to the rest of the world, the insolvency legal framework is very good

Source: http://www.doingbusiness.org/data/exploreeconomies/south-africa#resolving-insolvency

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# So what might we infer?

There's no need to infer, the summary is quite clear, and hints at the heart of the matter, which uttered more directly is:

*"Why is it that a firm that can be rescued in the OECD, will become insolvent in South Africa"*

Compared to a firm in financial distress in the OECD.

1. Where the overall insolvency and rescue framework is poorer!
2. The costs going to legal, court and admin are twice as much.
3. With half the expected recovery rate.
4. Taking marginally longer!
5. Resulting in many needless insolvencies which cost society dearly!
6. Of 100cents of value, in an OECD country roughly 20 cents of value is eroded on average as business face insolvency and survive or fail, whilst in SA more than 40 cents of value is destroyed.

We cannot blame the legislation as seems to be the general consensus, but then what are the underlying issues?

# Anecdotal evidence of business rescue points of failure



Prof Pretorius said banks and practitioners blamed each other. *"The practitioners blame the banks for not supporting business rescue, and the banks blame the practitioners for being incompetent."*

He warns *"The good business rescue practitioners are using it well but, just as with liquidations, there are lots of unscrupulous people. There are many complaints about exorbitant fees, practitioners stretching the process, failure to report."*

One of the weaknesses of the South African system, Prof Pretorius said, was that it had no dedicated courts with specialist judges. This had resulted in contradictory judgments being handed down. *"Every time a judge is appointed he might never have seen a case of business rescue and has to start from scratch,"* he said.

Also, as secured creditors, the banks tend to dominate*. "If the bank has more than 25% of the voting powers, it has full power, as you need 75% of the votes to approve a plan."* If they don't vote in the plan, the company goes into liquidation, which could be the better option for the banks, which often want their money quickly.

The Banking Association of Southern Africa's GM for regulatory and legal affairs, Nicky Lala Mohan, strongly rejected the suggestion banks were resistant.
"I don't think there is resistance. There have been a lot of business rescues that have gone through successfully with the co-operation of banks," he said. *"More often than not the business rescue proposition presented to the banks is a no-go from the start.*

The role of the businesses themselves seems largely ignored, and their failure to both communicate and implement measures of remediation.

Source http://www.bdlive.co.za/business/2014/08/06/business-rescue-under-scrutiny-as-remedies-fail-to-save-stricken-firms

# Contributing factors to poorer business rescue outcomes in SA.

SPARK SME SERVICES
COACHING – RESCUES – INVESTING

| Symptom | Cause | Result | Remedy |
|---|---|---|---|
| Businesses do not address issues of under performance when they are initially aware of them. | Cultural-across the demographic from the unwillingness to impart bad news to shame in perceived failure, outside help is never sought | eventual acknowledgment of problems makes them harder to address leading to continued under-performance and financial distress. Business rescue is that much more difficult and thus likely to fail. | If creditors allow access to their clients/debtors for informative and education sessions on good business practices, then we can equip them with cost effective tools and methodologies. |
| Businesses do not recognize root cause issues causing under performance, or address the wrong ones | SMEs do not have access to skills, methodologies needed to address the issues which are impacting their business | as above | As above |
| Business Rescue is used inappropriately. Without the correct investment in earlier turnaround efforts, such as a loan workout. Business rescue is expected to solve problems in a time period which is unrealistic | A poor understanding of the business rescue process itself, and the timeframe constraints. | Business Rescue plans are not approved, liquidation ensues. | If businesses appreciate the benefits of both timely remedial actions and also the benefits of an informal or formal loan workout, rescue applications will be reduced and those entering will be more successful. |
| Business rescue practitioners do not posses the skills and competencies needed to ensure successful rescue planning approval | The ability to appoint a business rescue practitioner is largely at the discretion of the business which is in distress. | Business Rescuing planning is not approved. | Creditors should be allowed a greater say in the appointment of Business Rescue Practitioners, who should meet more stringent requirements to practice. |

These are not insurmountable problems and provide an opportunity to banks and legal firms to provide a richer service offering to their clients.

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# The Spark Power Hour – Re-emphasis on the Informal Loan Workout

The Power Hour costs nothing, and is to the material benefit of under-performing firms

However, it is aimed at and should be useful for any struggling debtor, and when formalized can be a useful tool for creditors at risk

The Power Hour will provide actionable remedies that businesses should apply themselves in their own business.

The Power Hour will provide templates and background information so that the businesses can immediately attempt to apply these remedies themselves.

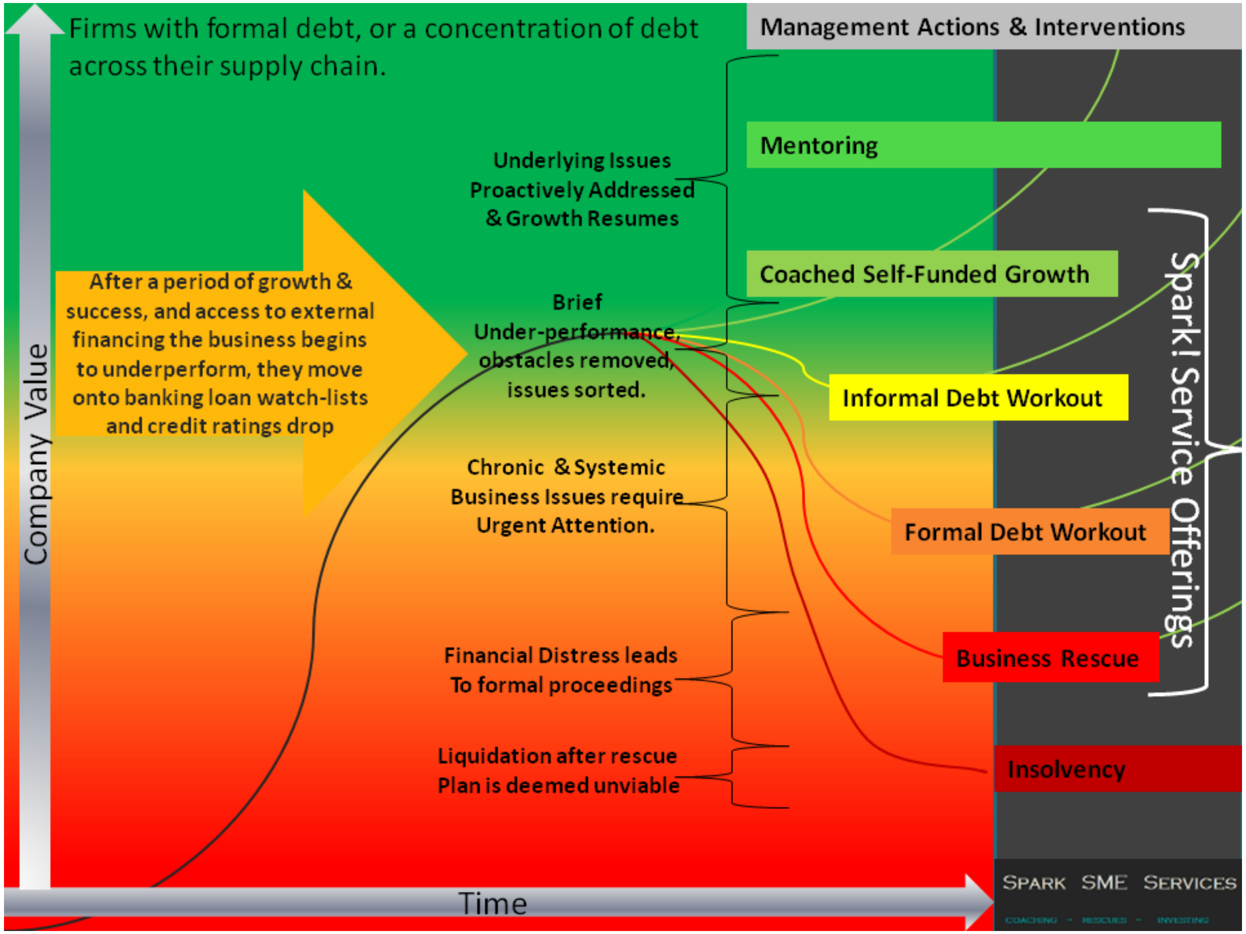
The Power Hour will provide contacts and references which are available to the businesses should they require any assistance.

The Power Hour will provide the "voice of legal", which will

- Warn of common mistakes which place businesses at a legal disadvantage
- Provide valuable insights into insolvency and restructuring practice.
- Reiterate clearly the key rights of lenders and debtor obligations under Company Law
- Provide legal reference sources for businesses to access

Spark SME Services
Coaching – Rescues – Investing

## There's a lot you can do before a business rescue! Use these options!




Blind optimism and hope alone are sufficient to see convergence to a single future – act now! We'll show you how!

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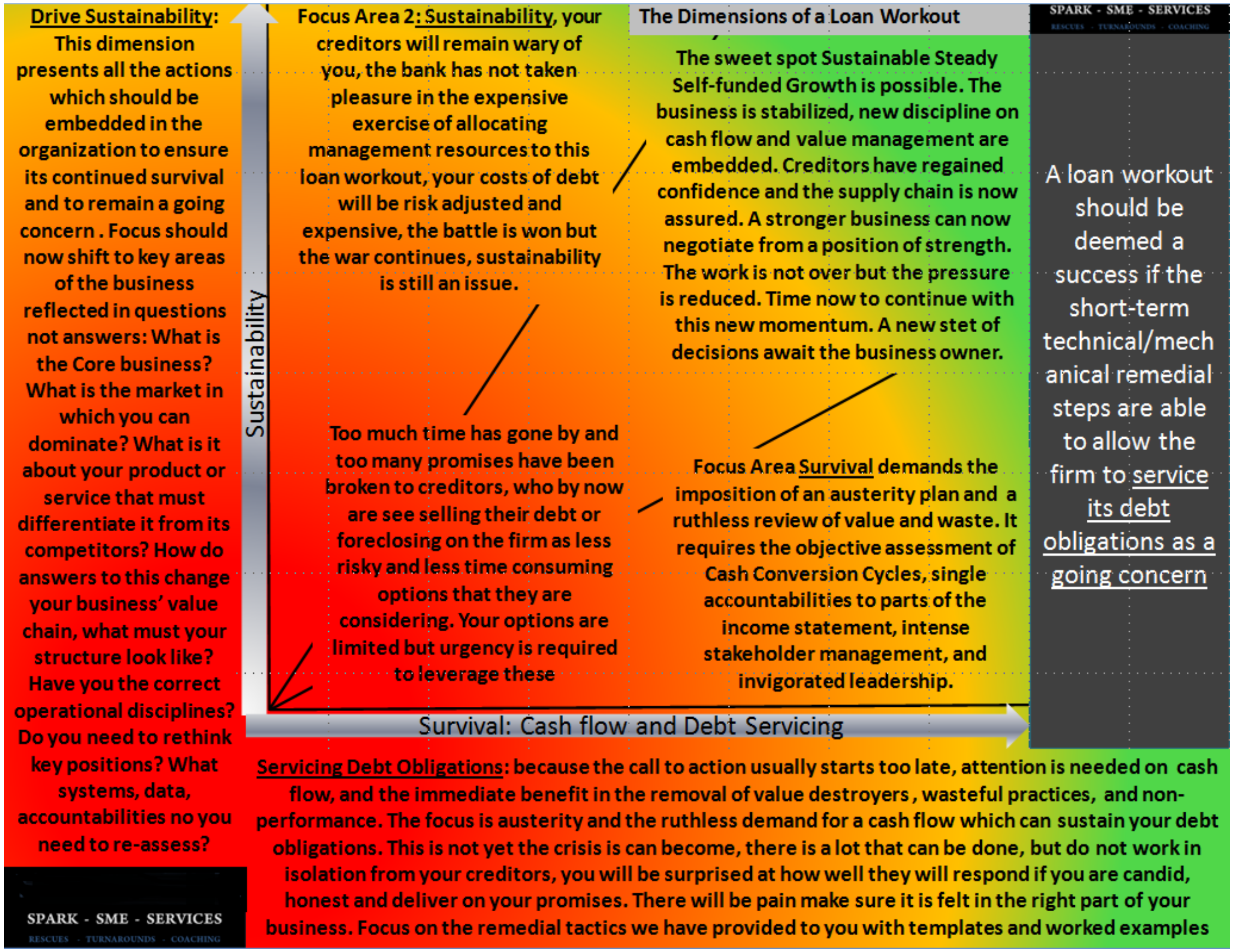
# Firms servicing large concentrations of non supply chain debt

## There are two dimensions to your loan workout, survival and sustainability.




We will share with you a methodology on entering a debt workout with some hope of reaching a compromise with your creditors.

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<u>What we cover:</u>

Tactic 1 – Understand what needs your attention, prioritize and focus – embrace austerity

Tactic 2 – Create alignment, assign accountability and ownership to key value drivers

Tactic 3 - Understand Value Destruction and waste, and remove it from your business

Tactic 4 – Operating Cash Cycles, use your cash effectively and remain self-funding.

Tactic 5 – Do and Don't from a Legal perspective

Each tactic comes with its own pack and worked examples and information about further online resources for the businesses to use.

We finish off with other potential areas of benefit capture in a pre-rescue situation.

This can be used informally between a parties as is but can also be packaged as a more formal and detailed solution offered by Insolvency and Restructuring Specialists to their clients, either those that are creditors at risk or delinquent debtors

# Appendix – Insolvency - Commencement of proceedings index

| Commencement of proceedings index (0-3) | | 3.0 |
|---|---|---|
| What procedures are available to a DEBTOR when commencing insolvency proceedings? | (a) Debtor may file for both liquidation and reorganization | 1.0 |
| Does the insolvency framework allow a CREDITOR to file for insolvency of the debtor? | (a) Yes, a creditor may file for both liquidation and reorganization | 1.0 |
| What basis for commencement of the insolvency proceedings is allowed under the insolvency framework? | (c) Both (a) and (b) options are available, but only one of them needs to be complied with | 1.0 |
| Commencement of proceedings index (0-3) | | 3.0 |

In so far as commencement of proceedings, we can't do much better!





Source: World Bank

| Management of debtor's assets index (0-6) | | 6.0 |
|---|---|---|
| Does the insolvency framework allow the continuation of contracts supplying essential goods and services to the debtor? | Yes | 1.0 |
| Does the insolvency framework allow the rejection by the debtor of overly burdensome contracts? | Yes | 1.0 |
| Does the insolvency framework allow avoidance of preferential transactions? | Yes | 1.0 |
| Does the insolvency framework allow avoidance of undervalued transactions? | Yes | 1.0 |
| Does the insolvency framework provide for the possibility of the debtor obtaining credit after commencement of insolvency proceedings? | Yes | 1.0 |
| Does the insolvency framework assign priority to post-commencement credit? | (see note) Yes | 1.0 |
| Note :over ordinary unsecured creditors but not over secured creditors | | |

In so far as debtor asset management, we can't do much better either!

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Source: World Bank

| Reorganization proceedings index (0-3) | | 2.5 |
|---|---|---|
| Which creditors vote on the proposed reorganization plan? | (see note) All creditors | 0.5 |
| Does the insolvency framework require that dissenting creditors in reorganization receive at least as much as what they would obtain in a liquidation? | Yes | 1.0 |
| Are the creditors divided into classes for the purposes of voting on the reorganization plan, does each class vote separately and are creditors in the same class treated equally? | Yes | 1.0 |
| Note :this is all creditors, but with conditions attached | | |

Some room for improvement but not much!

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Source: World Bank

| Creditor participation index (0-4) | | 3.0 |
|---|---|---|
| Does the insolvency framework require approval by the creditors for selection or appointment of the insolvency representative? | Yes | 1.0 |
| Does the insolvency framework require approval by the creditors for sale of substantial assets of the debtor? | No | 0.0 |
| Does the insolvency framework provide that a creditor has the right to request information from the insolvency representative? | Yes | 1.0 |
| Does the insolvency framework provide that a creditor has the right to object to decisions accepting or rejecting creditors' claims? | Yes | 1.0 |

OK, so there's some wriggle room for abusers of the framework





Source: World Bank