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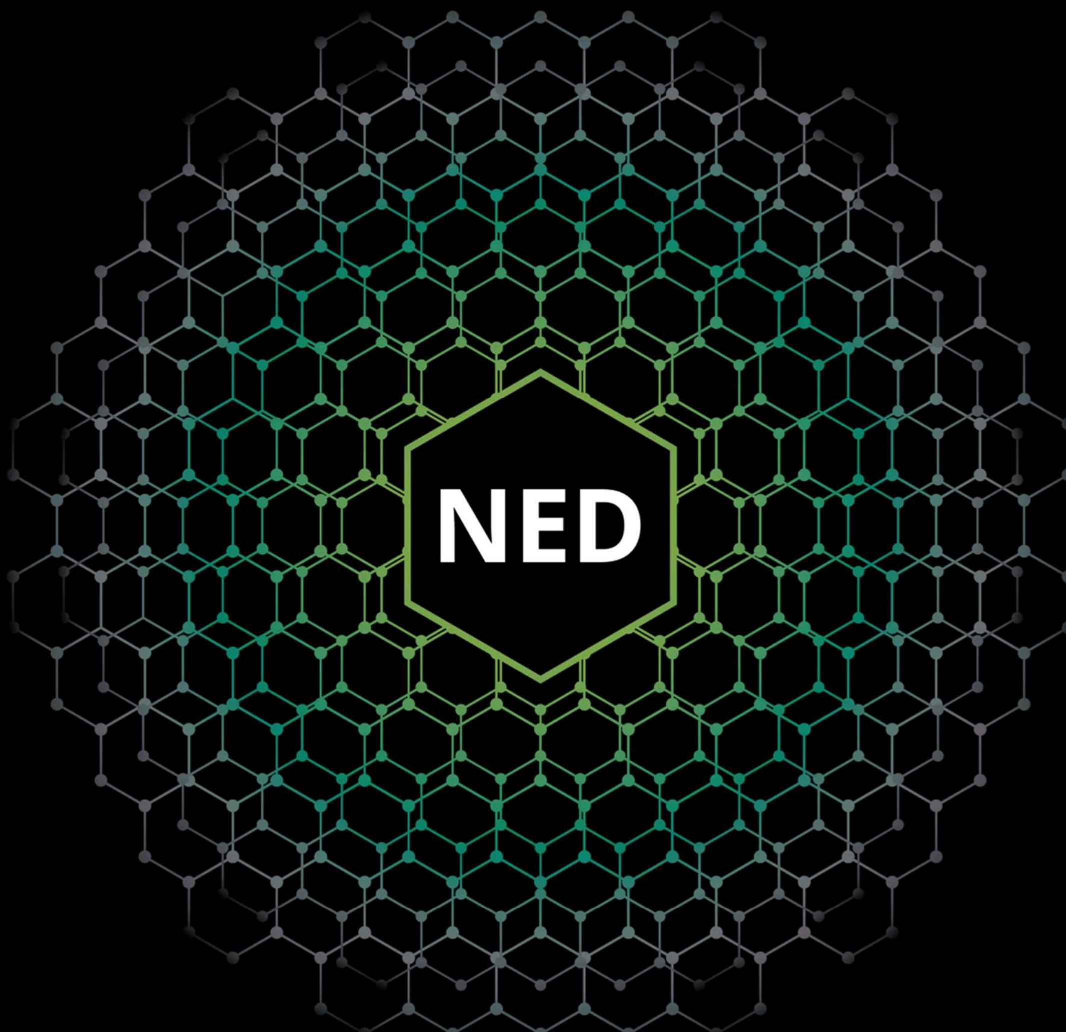

NEDs in Conversation (10 min read)

The role of the board in restructuring scenarios

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Summary of discussions | 25th March 2021

A rise in financial restructuring scenarios is predicted

Whilst many boards are facing the headwinds of 2020, early detection in financial restructuring scenarios is key.

Setting the scene

Economic growth is forecast to recover to 3.3% in 2021 and then moderate to 2.2% in 2022. However, there are many downside risks to these expectations including overall uncertainty around global conditions; the vaccine rollout; the path of the virus; electricity supply risks; ongoing weak business and consumer confidence; and other structural weaknesses which will challenge the country's chance of a sustainable economic recovery.

In the 2021 edition of the South Africa Restructuring Industry Survey report issued by Deloitte, 88% of respondents expect increased activity levels in the restructuring industry over the next 12 months.

Boards play a pivotal role in detecting the early warning signs of financial underperformance and distress, but these stretch far beyond diminished cash flow or breach of covenants.

Within the restructuring industry, experts talk about the 'demise curve' which outlines the many scenarios which companies may find themselves in from the early stages of poor financial health (where informal and consensual restructuring plans apply) to financial distress and indeed insolvency (where the options available to the company decrease as they enter into formal negotiations typically by the creditors).

While there are many and varied reasons why a business may find itself in need of financial restructuring across the 'demise curve', almost all survey respondents (94%) believe the probability of a company being turned around is 50% or greater if restructuring advice is sought when the early signs of distress become apparent.

A worrying trend within the survey, was that participants felt that companies are delaying seeking formal restructuring advice due to management teams and boards not believing that the financial distress warrants intervention (55%) and that management teams are concerned about being seen as incapable or incompetent (25%).

In this forum, exclusively for Non-Executive Directors, we convened a panel of restructuring experts to share lessons learnt and best practice in how the board should navigate financial restructuring scenarios.

Panel of speakers

Phahlani Mkhombo
Managing Director, Genesis Corporate Solutions

Ryan Wood-Collier
CEO of Greenpoint Capital

Haroon Laher
Partner, Fasken

Jo Mitchell-Marais
Restructuring Services Leader
Deloitte Africa

Supporting reading materials

“The six-month headroom outlined in Chapter 6 (of the Companies Act), can often feel like it passes by in six minutes.”

Haroon Laher, Partner, Fasken

“The Chief Restructuring Officer needs to be decisive and be able to make the tough decisions, often without the luxury of time.”

Phahlani Mkhombo
Managing Director, Genesis Corporate Solutions

Why is early intervention critical?

The panel outlined that early intervention allowed the board and management teams to conduct a diagnosis and apply remedial strategies to steer the business into a healthier business. If steps are taken early, creditors are generally more receptive to informal conversations which should be underpinned by a robust plan, and their risk appetite to restructuring the debt is more positive. This view is underpinned by the results of the Deloitte survey, which also interviewed representatives from the key lenders. The panel went on to advise that once formal proceedings were underway, the legal frameworks would dictate the conversations and actions which need to be taken.

What are the duties of directors in restructuring scenarios?

Under Chapter 6 of the Companies Act, a company is ‘financially distressed’ when it appears to be reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediately ensuing six months, or it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months.

Whilst NEDs do not have the benefit of the detailed operations of the business, they have the same obligations as executive directors.

The fiduciary duties of the director also extend to include a broad set of stakeholders, not just shareholders and creditors. Therefore, there is a personal liability risk associated with not taking the right steps as the board.

The value of the Chief Restructuring Officer and the skills and attributes which boards should be looking for

The panel agreed that the appointment of the Chief Restructuring Officer (CRO) was an integral step in the board seeking to take appropriate early action. The role of the CRO is to create an independent view and balance the rights and interests of all stakeholders in the development of a supporting and credible plan for the financial restructuring.

The panel suggested that CEOs typically don’t have the skills and experience required for turnaround scenarios. The skills required to be able to quickly assess the options available to the company; navigating and communicating to multiple stakeholder groups including the banks and trade unions; creating a pre-pack plan; and the negotiation skills required, are unique to these situations. To the extent that the CRO brings sector experience, that would be advantageous.

Existing management teams will still have a role to play in the process, and boards should ensure that they are freed up to support the actions required.

How is the South African restructuring market comparing to international trends?

The financial crisis of 2007-2008 saw the evolution of distressed investors and formalisation of the CRO role. When comparing South Africa to the UK and EU, the panel felt that in those markets, a CRO would be appointed much earlier in the process and that the advantage of having a credible plan well in advance of a formal restructuring scenario had resulted in many businesses avoiding liquidation and insolvency.

“CEOs typically don’t have the experience required. Understanding of the restructuring process is critical, including how to work with the creditors.”

Ryan Wood-Collier, CEO, Greenpoint Capital

What can boards do to proactively spot the early warning signs?

The panel shared the view that there is an emerging ‘reality gap’ which is prevalent at the early stages of financial restructuring scenarios. There was recognition that Non-Executive Directors, when compared to management teams, are disadvantaged by their distance from the detailed operations, and that they often receive perceptions of company performance. The recommendation was that the board should to take early action to understand the full truth.

Advice and tips for board directors

- Expect strong reporting from your management team with an emphasis on working capital and cash flows.
- Request a review or summary of the capital structures of the business with a key focus on liquidity; going concern; creditors’ rights; and the margin of safety which exists prior to lenders seeking formal remediation.
- Design a ‘financial health dashboard’ with the support of management teams, which will allow the board to spot trends and identify areas which may require deeper investigation. The dashboard should encompass the areas outlined in the graphic below.
- Take formal and independent advice as early as possible – this was described by the panel as the method for the board to conduct a ‘health check’ on the business.

Financial warning signs to consider restructuring advice

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This summary is based on a virtual event with the same title that was hosted by Deloitte Africa's deputy CEO, Sihlalo Jordan, on 25th March 2021. Speakers included:

- **Phahlani Mkhombo:** Managing Director, Genesis Corporate Solutions
- **Ryan Wood-Collier:** CEO of Greenpoint Capital
- **Haroon Laher:** Partner, Fasken
- **Jo Mitchell-Marais:** Restructuring Services Leader, Deloitte Africa