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The starting point for businesses facing distress

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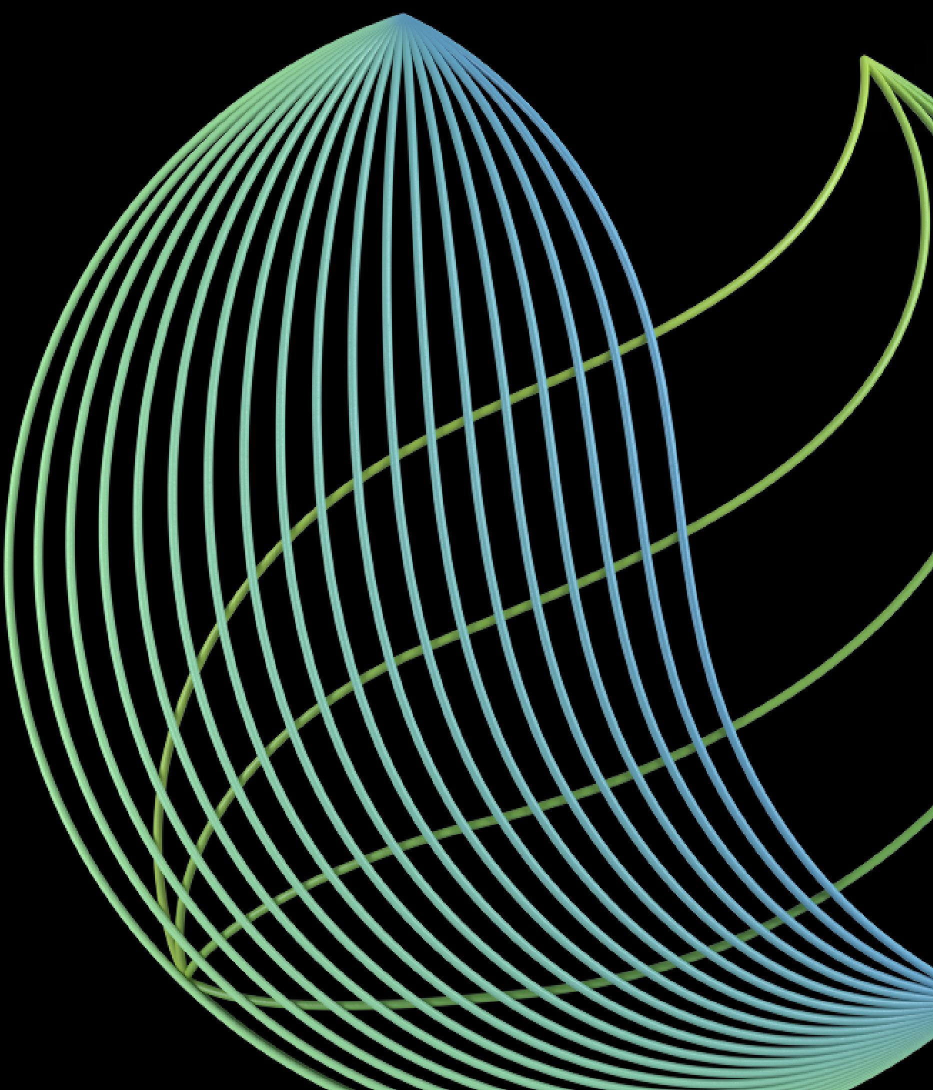

The starting point for businesses facing distress

From time to time, businesses go through periods of financial or operational distress. Business distress manifests itself in many ways, such as declining financial performance, missed budgets, delayed loan repayments, high employee turnover, or regulatory breaches. Delayed action addressing distress can result in detrimental consequences for the business, employees, financiers, and other stakeholders. Effects can include loss of market share, regulatory sanctions, penalties, or the business becoming insolvent and ending in liquidation. In cases where the entity survives and continues operating, delayed action can increase remediation costs. Therefore, key stakeholders, often management, financiers, and regulators, must understand how to initiate or compel action when dealing with distressed situations.

It is crucial that key stakeholders adequately understand what is causing the business distress. Management can conduct the review. However, due to the multiple stakeholders involved, a third party is usually selected to conduct the review in the interest of independence and objectivity. Restructuring professionals call such a review an Independent Business Review ("IBR").

What is an IBR?

An IBR is a rapid independent review of the financial and non-financial affairs of a business, and its prospects. An IBR can be commissioned by the business, shareholders or financiers (normally after a triggering event under their security). An IBR aims to achieve three key outcomes:

1. Crystallizing the current situation;
2. Understanding the key value drivers and issues affecting the business; and
3. Providing recommendations and a roadmap of the next steps.

In crystallizing the current situation, an IBR captures the current status of a business and changes in its diverse facets, such as the market and stakeholder landscape, revenue, profit margins, and cost drivers. Understanding the reasons behind the changes is essential as it points to the fundamental focus areas in addressing distress. Ultimately, an IBR is only useful if it answers stakeholders' concerns on what actions to take and in what priority. This is the zenith of an IBR.

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What is the typical scope for an IBR?

There is no set scope for an IBR – it primarily depends on the purpose of the IBR and the nature of the distress. In situations where it is the business that commissions an IBR, it should ensure that the IBR addresses the concerns of its key stakeholders, such as financiers. This is especially the case since, in our experience, distressed businesses often rely on an IBR to seek financial support in the form of additional funding or renegotiation of existing terms with their lenders. Therefore, ensuring that the IBR speaks to aspects that financiers will consider in evaluating the business' request increases its chances of success.

The scope of an IBR can encompass a business overview, industry benchmarking, historical and forecast financial performance, operational performance and drivers, cash flow forecast, working capital analysis, balance sheet review, value break analysis, lenders' security review, opportunities to capture value, and recommendations.

Time is of the essence

In a distressed situation and in conducting an IBR, time is vitally important. The chances of salvaging a business while management is in control depend on how quickly key stakeholders can mobilize to understand the distress and to take steps to rectify the situation.

Management and directors should be aware of their statutory and fiduciary duties. In particular, directors should understand the solvency status of the business as this informs the point at which they should expand their duty of care to include creditors.

IBR as a tool for regulatory compliance

In responding to or addressing regulatory breaches, regulators, or even the business, should consider whether a review, akin to an IBR, is appropriate. For the business, engagement with the regulator could improve since, by commissioning an IBR, it acknowledges its challenges and shows its desire to rectify the situation. From a regulator's perspective, in some situations, an independent and objective review of the status of the business could inform appropriate and timely remediation measures – by providing an outsider's perspective, especially where the consequences of a breach are dire such as a petition to wind up the entity. An IBR can take up to four weeks (or less) to complete and therefore is suited for a fast-paced business and regulatory environment.

Recommendations

An IBR is not a one size fits all approach, and the recommendations are specific to the instructions and findings of each IBR. Each IBR considers the particular point where the business is at along the demise curve. Generally, turnaround or other performance improvement approaches are possible in the early stages of distress. Balance sheet restructuring or accelerated M&A is the most feasible option if the business is further down the demise curve. In the worst-case scenario, liquidation or other insolvency processes could be the only options left. The type of recommendation additionally highlights the need for timely action by key stakeholders in distress situations.
In our experience, once decision-makers adopt recommendations, some form of monitoring helps to keep management and all stakeholders on track during the implementation phase. In addition, the monitoring ensures that the recommendations get implemented as desired and addresses any deviations from the adopted recommendations as soon as possible, increasing the odds of success.

By recognizing early warning signs of distress and understanding where to start in dealing with the same, key stakeholders, especially management, financiers, and regulators, increase the odds of rescuing a business facing distress.

About the author

Danvas is an Insolvency & Restructuring Manager at Deloitte. He has over 6 years of multi-jurisdictional experience supporting distressed and insolvent businesses in Eastern Africa and the Caribbean & Bermuda regions. His experience encompasses both out of court restructuring and court supervised reorganizations through company administrations, receiverships, liquidations, business reviews, financial advisory and financial restructuring.

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