



the dti

Department:
Trade and Industry
REPUBLIC OF SOUTH AFRICA



Improving turnaround and business rescue in South Africa

How government can contribute, and how TMA-SA can assist

**Presentation to the Department of Trade and Industry,
and to National Treasury**

**By the Turnaround Management Association –
Southern Africa**

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6 November 2006

***The premier professional community dedicated to
corporate renewal and turnaround management***



Southern Africa

While this presentation addressed issues at a high level, TMA-SA offers to research and compile more detailed information if needed.

The turnaround industry in South Africa:

- **Turnaround situations**
- **Causes of distress**
- **Turnaround strategies**
- **Turnaround industry in South Africa**
- **Turnaround industry driving forces**
- **Turnaround industry constraints**
- **Government interventions**

The turnaround industry in South Africa:

- **Turnaround situations**

- What constitutes a turnaround situation?
- Measuring financial distress
- Timeline of financial distress
 - Management-led correction
 - Informal creditor workout
 - Business rescue

What constitutes a turnaround situation?

Broad view

- A company in need of restoration of corporate value, whether it ...
- exhibits symptoms of decline...
- is underperforming...
- or in distress.

Wider view

- “To produce a noticeable and durable improvement in performance...
 - to turn around the trend of results from down to up,
 - from not good enough to clearly better...
 - from underachieving to acceptable ...
 - from losing to winning.”
- Stanley J. Goodman*

Narrow view

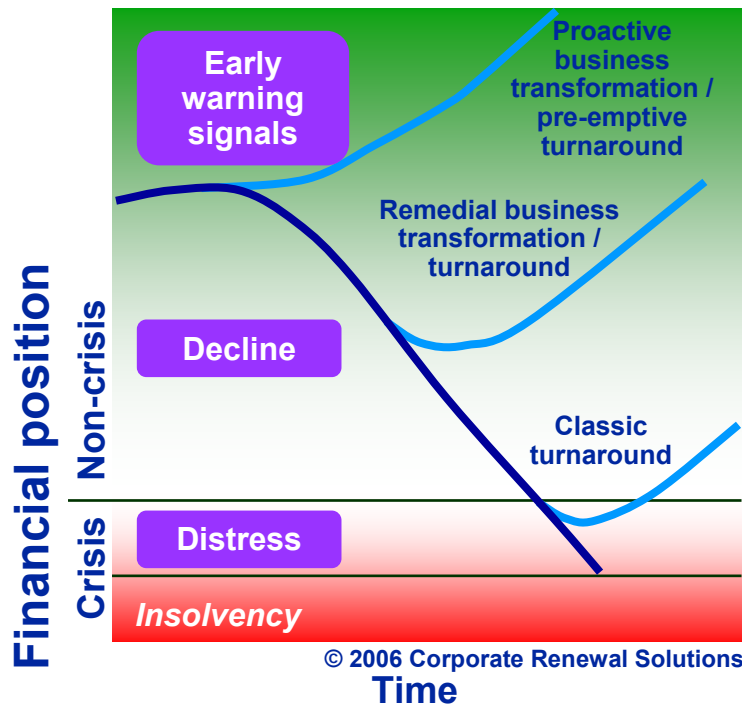
“Firms whose financial performance indicates that the firm will fail...
in the foreseeable future...
unless short-term corrective action is taken.”

Stuart Slatter and David Lovett

The modern trend is to view a turnaround situation as a company in need of restoration of corporate value irrespective of its financial state.

Restoration of corporate value deals with companies ranging from healthy to severely distressed

Restoration of corporate value



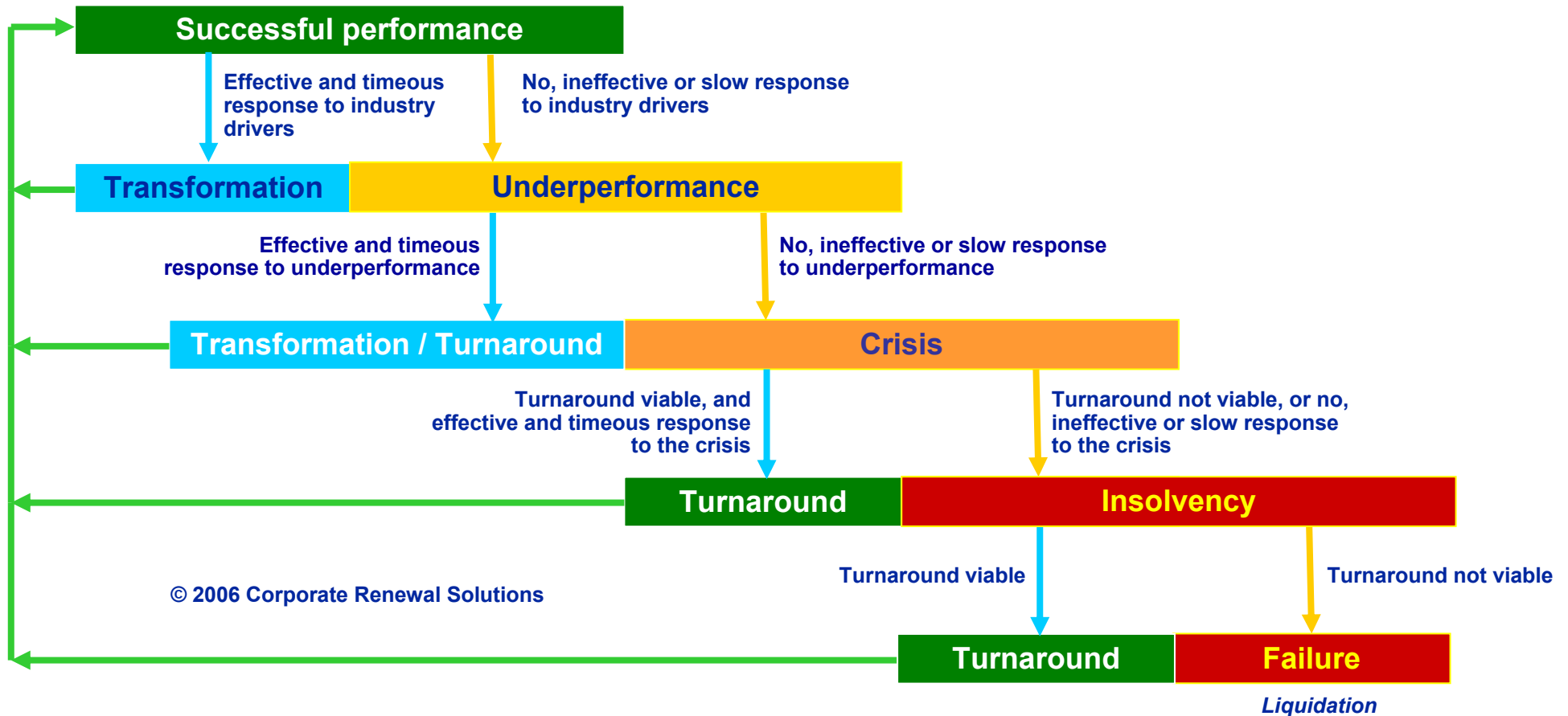
Note: business transformation = corporate renewal

Turnaround situation	Financial situation	Management	Systems
Exhibiting symptoms of decline	Early warning signals	Intact	Intact
Under-performing businesses	Under-performance	Intact	Intact
Distressed businesses	Distress	Intact?	Intact?
Deep turnarounds	Severe distress	Good managers have left	Broken systems

The classic turnaround can be prevented by timeously acting on early warning signals and resolving underperformance.

No, ineffective or slow response to industry drivers, underperformance or distress leads to liquidation

From success to failure:



South Africa is waiting for new business rescue legislation to make turnaround during insolvency more successful

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The financial health of a business can be accurately determined for any performance situation

Z-Score:

- Thoroughly tested and broadly accepted distress-prediction model
- Developed by Professor Edward I. Altman of the Stern School of Business at New York State University:
 - Active participant in the Turnaround Management Association
 - Chairs the association's Academic Advisory Council.
- The Z-Score applies statistical techniques (Multiple Discriminant Analysis) to financial ratios (profitability, solvency, cash, etc.) to determine the overall health status of a business:
 - Healthy Zone: Business is in good shape
 - Danger Zone (zone of ignorance, zone of uncertainty): Warning signals, exercise caution
 - Failing Zone: High likelihood of bankruptcy within one year



Note that there is are Z^1 , Z^2 and Z^3 Scores depending on listed vs. unlisted, and manufacturing vs. non-manufacturing.

The most daunting task faced by turnaround practitioners is turnarounds that are triggered to late – the rule rather than the exception

- **Turnaround action should ideally commence:**

- When the Z-Score starts declining
- At the latest when a company enters the Danger Zone

“It is far easier to tread on an acorn than on an oak tree” – Neil Harvey.

- **In practice, however, turnarounds:**

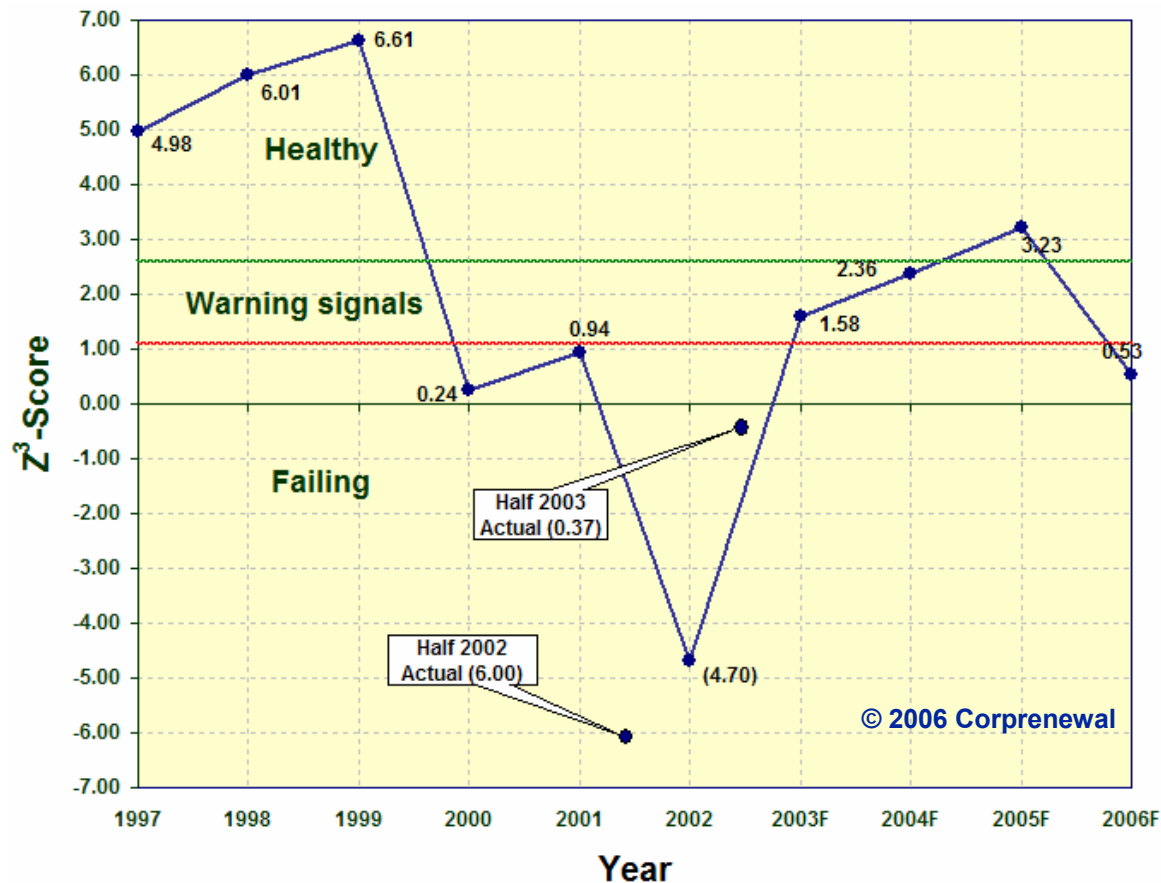
- Suffer from late starts, or
- They take too long before taking the shape of a serious turnaround intervention

- **Once in the Failing Zone, the business is, in the absence of turnaround action, likely to be bankrupt within a year (95% probability)**

- **This situation presents turnaround practitioners with the most difficult scenario possible - that of the "deep turnaround":**

- Banks will not lend
- Difficult, if not impossible to find private equity funding
- Suppliers stop supplying, tighten up on credit terms and/or ask for upfront payment
- Key clients will not buy or hedge their bets by shifting their purchases to more stable competitors
- Key staff are long gone to better situations or preparing to move

Let's look at an example of how the Z-Score was used to forecast turnaround results at a listed distressed company



A business in the Failing Zone has a 95% chance of formal bankruptcy, but can be turned around.

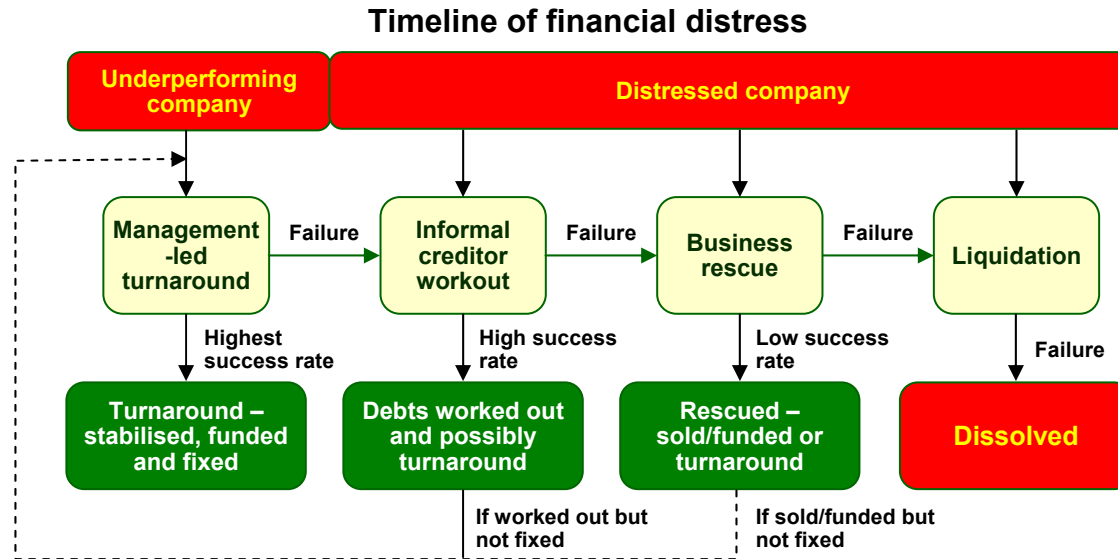
- R400m T/O listed company
- Z-Score graph reflects history up to 2002, and thereafter the turnaround plan inclusive of debt repayment schedule agreed with bank (informal creditor workout)
- Share price was R0-35 in 2002
- Company not insolvent
- Turnaround plan attracted R20m private equity investment at R1-20/share (not reflected in Z-Score)
- Share price increased to R2-00 within months
- Company adhered to bank debt repayment schedule
- 2006: forecast problems realised, share price dropped, bottom 5% of its sector on stock exchange

The turnaround industry in South Africa:

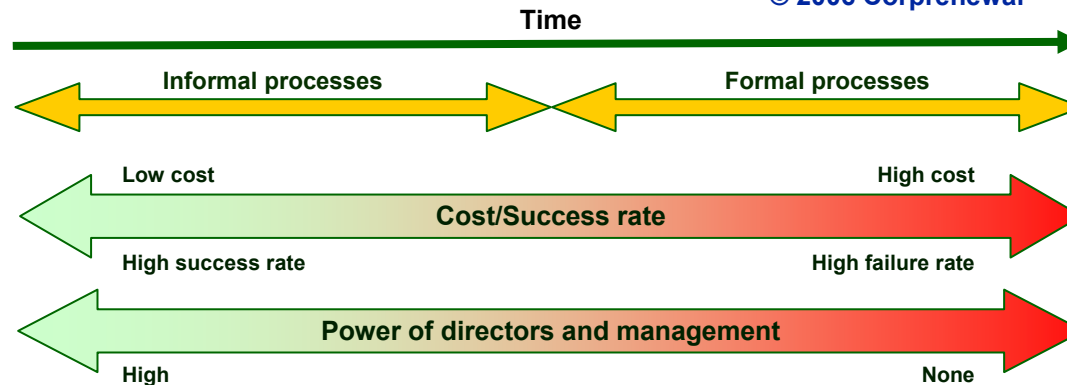
- **Turnaround situations**

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As a troubled business moves along the timeline of financial distress, costs increase, but the success rate and management power decrease



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The timeline of financial distress illustrates how remedial processes are applied during different stages

The stages and processes in the timeline of financial distress:

Informal Processes		Insolvency Processes			
<i>Emerging problems</i>	<i>Acute and worsening problems</i>			<i>Insolvency but possible viability</i>	<i>Insolvency and unlikely viability</i>
Management-led correction		Informal creditor workout	Business rescue		Liquidation
			Pre-packaged	Free-fall	
No creditor and legal issues since the financial situation is not yet critical	Critical financial situation but no creditor pressure, due to support from benevolent shareholders (e.g. distressed government organisations, SOEs and companies with financial support from holding companies)	Informal agreement between management and creditors (banks) to reduce indebtedness Terms of workout agreement dictates agenda	<u>Present:</u> none	<u>Present:</u> judicial management and Section 311 Compromise of Creditors Very low success rate	Realisation of the distressed company's assets and the distribution of proceeds to its creditors
			<u>Future:</u> Invoked when not yet insolvent Higher success rate than free-fall	<u>Future:</u> Invoked once insolvent Lower success rate than pre-packaged	
Management retains the initiative and controls the turnaround agenda		Banks hold the power	Court-driven – inflexible and expensive		

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The timeline of financial distress is adapted and extended from Matthias Kahl, "Economic distress, financial distress, and dynamic liquidation", Journal of Finance 62 (February 2002) pp.135-168
Used by the G10's Contact Group on the Legal and Institutional Underpinnings of the International Financial System to describe insolvency arrangements and contract enforceability

What are the costs of financial distress, and how is the success rate defined?

Direct costs:

- **Management consulting fees**
- **Accounting fees**
- **Legal fees**

Indirect costs:

- **Additional management time**
- **Loss of employees, customers and suppliers**

Success rate:

- **Claimholder recovery rate – traditional measure used by insolvency industry**
- **Company survival rate – more in the spirit of the new business rescue culture**
- **Job retention rate – we would like to see this measure too**

To which stages does turnaround apply?

Turnaround and the timeline of financial distress:

<i>Informal processes</i>		<i>Insolvency processes</i>	
<i>Management-led correction</i>	<i>Informal creditor workout</i>	<i>Business rescue</i>	<i>Liquidation</i>
Turnaround applies by definition	<ul style="list-style-type: none"> • Turnaround applies where the intention is to trade a distressed business out of trouble rather than to work out loans to an extent and then liquidating 	<ul style="list-style-type: none"> • Judicial management – not applicable • Section 311 Compromises of Creditors – could be • New business rescue legislation - turnaround can take place within formal legal procedures for the first time 	Turnaround hardly ever applies <div style="border: 1px solid black; padding: 5px; background-color: #e0f0ff;"> <i>The turnaround and insolvency industries are both involved in business rescue, but from different perspectives.</i> </div>
<i>Turnaround industry</i>		<i>Insolvency industry</i>	

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Turnaround should ideally occur as management correction

Management-led turnaround:

Where and when

- Companies where early warning signals of impending distress are recognised early enough and acted upon
- Companies that are underperforming but not in financial distress
- **Distressed companies supported by benevolent shareholders:**
 - Distressed subsidiaries of strong groups which support management-led correction financially
 - Organisations in the public sector

Further characteristics

- Triggering normally by a concerned Board of Directors
- Most turnarounds take place in the form of management correction
- **Examples:**
 - SA Post Office (Maanda Manyetshe)
 - Edgars (Stephen Ross)
 - Transnet (Maria Ramos)
 - SAA (Khaya Ngqula)

Benefits

- **For directors and management:**
 - Directors and management remain in charge of the agenda
- **For creditors:**
 - Action is taken by management to protect the exposure of creditors without the need for creditors to intervene or to invoke a formal insolvency process
- **For all**
 - Highest success rate and the lowest cost of all processes applied to troubled companies

Failure of management to react timeously and successfully to early warning signals of distress normally leads to intervention by creditors.

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Should management-led correction fail, creditors – normally the bank(s) intervene

Informal creditor workout:

Where And When

- **Acute and worsening problems impair a company's ability to meet its commitments to its financial and trade creditors**
- **This normally leads to creditor intervention**
- **A workout follows negotiated agreement outside the legal framework i.e. out-of-court settlement on a plan to reduce indebtedness**

Role Of Banks

- **Strong workout capability:**
"Special portfolio", "credit recovery" or "intensive care" departments in credit or risk management structures
- **Cannot participate in the management or intervene in the affairs of a troubled company, since the rights of other creditors may not be prejudiced**
- **Yet, banks have considerable influence e.g. make continued and/or further support conditional to an independent review of the affairs of a troubled client, and conditional to the submission of credible turnaround plan**
- **In a multi-banked situation a consortium may be formed, which is of great help to make a turnaround work**
- **In a consortium, normally under independent chairmanship, affected banks join forces to:**
 - Ensure a common approach to the problem
 - Ensure that no single lender steps out of line and prejudices the overall situation for the other lenders
 - Sometimes spread the risk

Informal creditor workouts have advantages, but serious disadvantages too

Informal creditor workout (2):

Advantages

- **For directors and management:**
 - Secrecy, avoiding the stigma of a more public formal procedure such as business rescue (and avoiding investigation and challenge of directors' conduct).
 - Cost savings relative to formal business rescue
- **For all:**
 - Flexibility in the absence of legal procedures
- **Success rate (Franks and Sussman study of UK banks):**
 - 75% turned around or switched banks
 - Average time 7,5 months

Disadvantages

- **For directors and management:**
 - Although management remains in charge, the agenda is determined by the terms of the workout agreement
- **For banks:**
 - Degree of "free-riding" by other creditors such as trade creditors and SARS, who offer little by way of solutions, finance and sharing in the risk during the workout, but who share in the benefits should the workout be successful
 - Dissenting creditors, normally the smaller ones, may derail the workout by reverting to formal insolvency laws
 - Have to rely on management's promises, capabilities and integrity to execute a turnaround plan
 - Should a company go into liquidation following an unsuccessful workout, banks run the risk of being accused of having favoured themselves during the workout
 - Banks are often blamed if job losses occur as a result of the workout

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Business rescue has a number of objectives and benefits

- **The purpose of business rescue is to preserve the going concern value of a distressed firm, that is or is going insolvent but potentially viable, through:**
 - Refinancing/financial restructuring, or
 - Turnaround (including refinancing/financial restructuring), or
 - Keeping it afloat and selling it as a going concern (for turnaround/refinancing by the buyer)
- **A firm that enters business rescue and emerges intact may satisfy creditors' claims more effectively than a firm that is liquidated**
- **Business rescue is meant to allow a distressed firm to:**
 - Satisfy claims of creditors
 - Continue in the economic stream i.e. source of business for other companies
 - Preserve jobs and create employment
 - Pay taxes

However, SA's business present antiquated business rescue legislation does not achieve these benefits.

The turnaround industry is looking forward to new business rescue legislation as per Chapter 6 of the new Companies Act

Debtor-friendly:

- **The latest draft represents a reversal of the hitherto creditor-friendly approach**
- **The Supervisor (previously called Business Administrator):**
 - Can be appointed by the company (debtor-friendly)
 - Previously by creditors (creditor-friendly)
- **The board and directors of a company:**
 - Must continue to perform and exercise their functions and powers, subject to the authority of the Supervisor (debtor-friendly) who can veto decisions and remove management
 - Previously lost all powers to the Business Administrator (creditor-friendly)
- **Committee of employees, or of creditors:**
 - May consult with the Supervisor about any matter relating to the business rescue proceedings, but may not direct or instruct the Supervisor (debtor-friendly)
 - Creditors previously controlled the Business Administrator (creditor-friendly)
- **Creditors, however, must still approve the business rescue plan**

New business rescue legislation will provide more protection and time for a troubled company to rearrange its affairs and survive

Protection and more time:

- **A moratorium on the rights of claimants and legal proceedings against the company:**
 - No interest, capital, creditor payments....
 - Moratorium will overcome two of the weaknesses of the informal creditor workout:
 - It represents cram-down of dissenting minority creditors who cannot derail the process any more
 - Banks don't face the problem of free-riding other creditors any more
- **Ring fencing and ranking as to preference of creditors' interests:**
 - Post-commencement finance ranks highest (but in free-fall business rescue it is unlikely that there will be any unencumbered assets)
- **No time limit on the duration of business rescue as long as it is working (debtor-friendly)**
 - Previously there was a time limit (creditor-friendly)
- **Allows for pre-packaged business rescue**

TMA-SA has a number of questions on the draft legislation

Questions:

- **A number of TMA-SA members have provided dti with comments on the draft legislation in their private capacities**
- **TMA-SA wish to discuss how the industry will be regulated, how supervisors will be appointed, etc.**
 - Overseas, TMA has 7000 members involved in business rescue
 - Many of them are formally appointed to effect business rescue e.g. Chapter 11
- **TMA-SA also seeks clarity on the relationship between the supervisor and other consultants used:**
 - In the informal sector, a turnaround firm employs a team in a distressed company
 - It seems that in terms of the draft legislation, a turnaround firm can supply either of the supervisor or the consultants, but not both?

TMA-SA's interest is to make new business rescue legislation work in practice.

Business rescue, however, is not a silver bullet for distressed companies - as illustrated by overseas statistics

High cost:

- Direct costs represent 24% of book value on entering business rescue (Nachtman et al, 1999) but still less expensive than liquidation (the move towards pre-packaged from free-fall business rescue will reduce costs though)

The success rate has improved after the introduction of pre-packaged business rescue

Low success rate – the USA experience:

- Baker Smith, President of Morris-Anderson: "Since over 85% of businesses never successfully emerge with a confirmed plan of reorganization, the cure must be worse than the illness. Most companies die in Chapter 11. Unless a company's underlying problems are addressed with a turnaround plan or sale, Chapter 11 can't ultimately save them."
- Many firms increase their investment expenditures only by very little in the first two years after a debt restructuring (James 1995)
- In each of the first five years after emerging from business rescue, between 35 percent and 41 percent of all firms have negative operating income (Hotchkiss 1995)
- More than 75 percent of firms that complete debt restructurings emerge with a leverage ratio that is higher than industry median and most are still significantly more highly leveraged than before the onset of financial distress (Gilson 1997)
- Furthermore, between one quarter and one third of all distressed firms re-enter financial distress within a few years after completing a debt restructuring (Hotchkiss 1995 and Gilson 1997)

The success rate of business rescue is low because (1) it is wrongly deemed to be a measure of last resort and (2) has too little emphasis on turnaround

Why a low success rate?

- **Formal business rescue is expensive:**

- To save costs, management-led correction and informal credit workout are still attempted when formal business rescue should already be taking place

- **Stigma of bankruptcy:**

- In countries with a legacy of English law like SA, business rescue carries the stigma of bankruptcy, leading to loss of prestige, staff and customers
- This is in contrast to Chapter 11 in the USA where bankruptcy carries less of a stigma

- **Resistance of directors and management:**

- Less so with Chapter 11 in the USA where directors and managers remain in charge (DIP or debtor-in-possession principle)
- But more so in non-Chapter 11 jurisdictions since directors and management lose control

As a result of the 3 points above, a business tends to be too deep in the Failing Zone of the Z-Score by the time that business rescue is triggered.

- **Focus on “restructuring” instead of “turnaround inclusive of restructuring”**

Apart from new business rescue legislation, we identified a number of key success factors for business rescue in South Africa

<i>Business rescue key success factors</i>	
<i>Avoid the need for business rescue</i>	<ul style="list-style-type: none"> • Avoid formal business rescue by educating business in timeous and effective reaction to early warning signals of distress
<i>Expedite business rescue if the need cannot be avoided</i>	<ul style="list-style-type: none"> • A stronger legal deterrent to directors trading under insolvent conditions (in new Companies Act?) • Avoid “free-fall” business rescue - don’t start looking at solutions only once insolvent • Instead, use “pre-packaged” business rescue: <ul style="list-style-type: none"> – Timeously devise a turnaround plan inclusive of financial restructuring and then invoke business rescue before real financial distress has set in – This hybrid takes the form of the informal creditor workout with its low costs, but invokes business rescue to achieve the protection offered by the latter.

Business rescue key success factors ... (2)

Business rescue key success factors

Don't attempt to rescue a lost case

- The purpose of business rescue is to avoid making a Type 1 error
- Type 1 error = to liquidate businesses that should be rescued
- Conversely, Type 2 error refers to attempting to rescue businesses that should be liquidated
- Cost of Type 2 error = cost associated with the unsuccessful rescue attempt plus the cost of subsequent liquidation

Business rescue key success factors ... (3)

Business rescue key success factors

Turnaround, not mere restructuring

- **Financial restructuring alone is OK if EBITDA/operating profit is positive, but losses are incurred due to the interest burden**
- **But businesses with strategic, organisational and operational challenges require more than restructuring to survive**
- **If distressed businesses are not stabilised and the underlying causes of distress are not fixed through turnaround action, the business will not survive restructuring**
- **Business can in legal terms be “rescued” by selling it – but that still leaves turnaround to the buyer**

Unless the business is fixed, "business rescue" postpones the inevitable.

Business rescue key success factors ... (4)

Business rescue key success factors

Turnaround finance

- **Need for a stronger turnaround private equity industry in South Africa that:**
 - Not only invests in underperforming businesses and businesses requiring financial restructuring ...
 - ... but also invests in distressed businesses too
- **New business rescue legislation will stimulate the market for distressed situation private equity**

Business rescue cannot happen without a cheque book.

Business rescue key success factors ... (5)

<i>Business rescue key success factors</i>	
<i>Organised industry</i>	<ul style="list-style-type: none"> • Turnaround Management Association - Southern Africa: <ul style="list-style-type: none"> – Promotion of the turnaround and business rescue industries – Information exchange, networking, education and raising the standards of turnaround across both the informal and formal sectors • Need for a business rescue regulatory body setting admission requirements
<i>Education</i>	<ul style="list-style-type: none"> • Education of industry and government through TMA-SA • Educational conferences like this one today • Certified Turnaround Professional (CTP) qualification: <ul style="list-style-type: none"> – TMA-SA's future programme to educate turnaround practitioners – Exam on (1) turnaround management (2) financial, managerial and tax accounting (3) law – Proven track record and experience

Business rescue key success factors ... (6)

Business rescue key success factors

Business rescue scorecard

- **The success rate of business rescue overseas is low**
- **However, expectations from government and the press will be high**
- **We therefore call for a scorecard to measure and track the success of all business rescue attempts under new legislation:**
 - Number and turnover of businesses that survive business rescue
 - Percentage of jobs retained as a result of business rescue
 - Claimholder recovery rate as a result of business rescue
 - Cost of business rescue
 - Restructuring, turnaround or sale

The turnaround industry in South Africa:

- Turnaround situations
- **Causes of distress**
- Turnaround strategies
- Turnaround industry in South Africa
- Turnaround industry driving forces
- Turnaround industry constraints
- Government interventions

Causes of distress are both internal to a company, and external

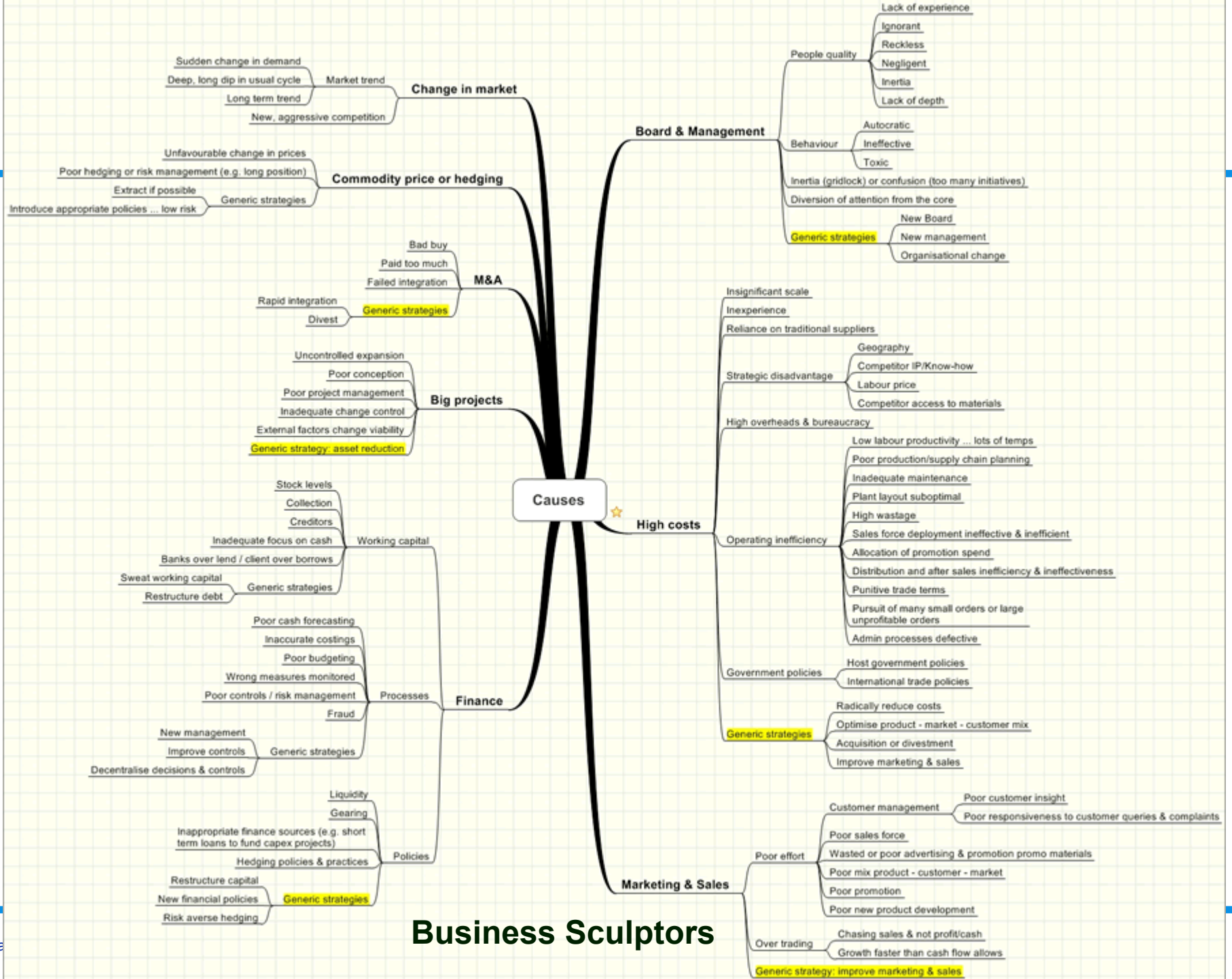
Causes of distress:

Studies of causes of distress		Schudel	Bibault	Slatter	Thain & Goldthorpe	Grineyr	Gopal	Gething
Internal causes	Management issues	✓	✓	73%	✓	✓	✓	84%
	Poor financial control		✓	75%	✓	✓	✓	60%
	High cost structure	✓		35%	✓	✓		56%
	Poor marketing	✓		22%	✓	✓		20%
	Big projects	✓		17%	✓	✓		20%
	Acquisitions			15%				72%
	Financial policy			20%	✓		✓	84%
External causes	Changes in market demand	✓	✓	33%	✓	✓	✓	68%
	Competition	✓	✓	40%	✓	✓	✓	44%
	Adverse commodity prices	✓	✓	30%	✓		✓	20%
	Government policy	✓	✓				✓	
	Strikes	✓						
	Bad luck		✓				✓	

Internal causes of distress are almost always related to management

Source: Corporate Turnaround – Stuart Slatter & David Lovett 1999

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Business Sculptors

Example from a sample provided by a SA bank – note the high incidence of fraud

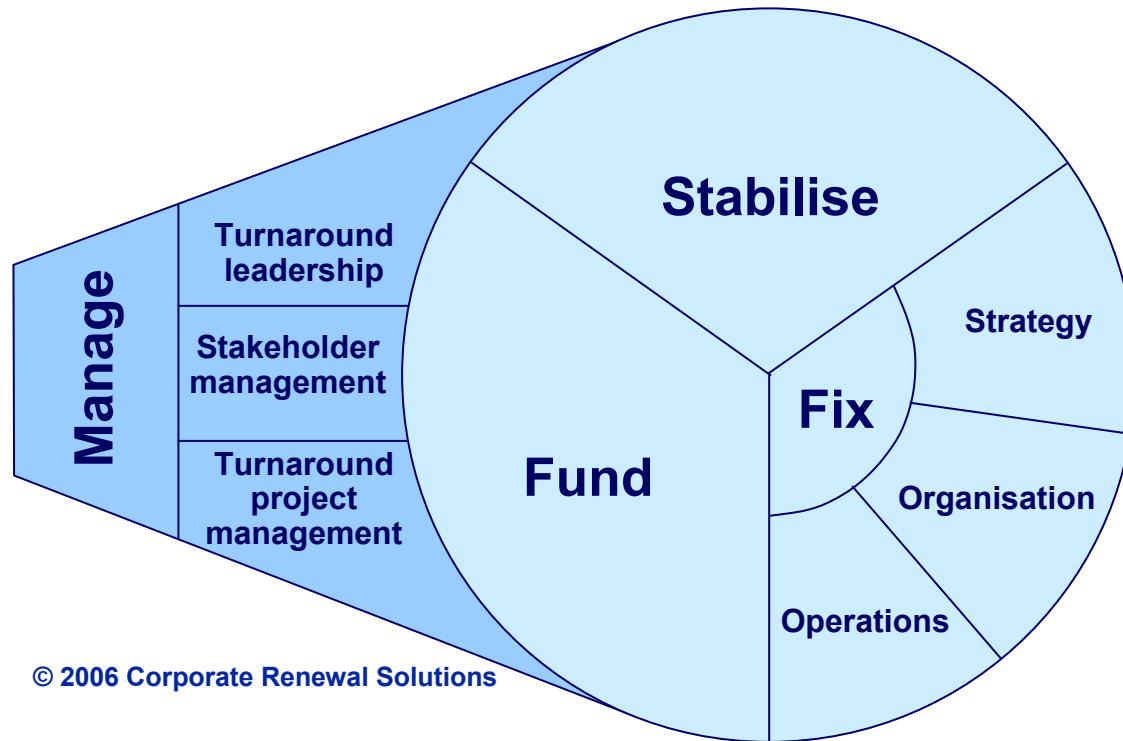
Sample	Could be saved = Y	Could be saved = N	<u>Reasons for Failure</u>					<u>Solutions</u>				
			Fraud	Mgmt	Work Capt	Not Viabl e	External Factors	New Mgmt	Capt/equity	Creditor assist	Business Restructure	
44	15	29	Overall	16	10	5	7	6				
			Y	4	2	5	2	2	10	5	2	7
			N	12	8	0	5	4				

The turnaround industry in South Africa:

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Turnaround situations need to be stabilised, funded and fixed – and managed under turnaround conditions

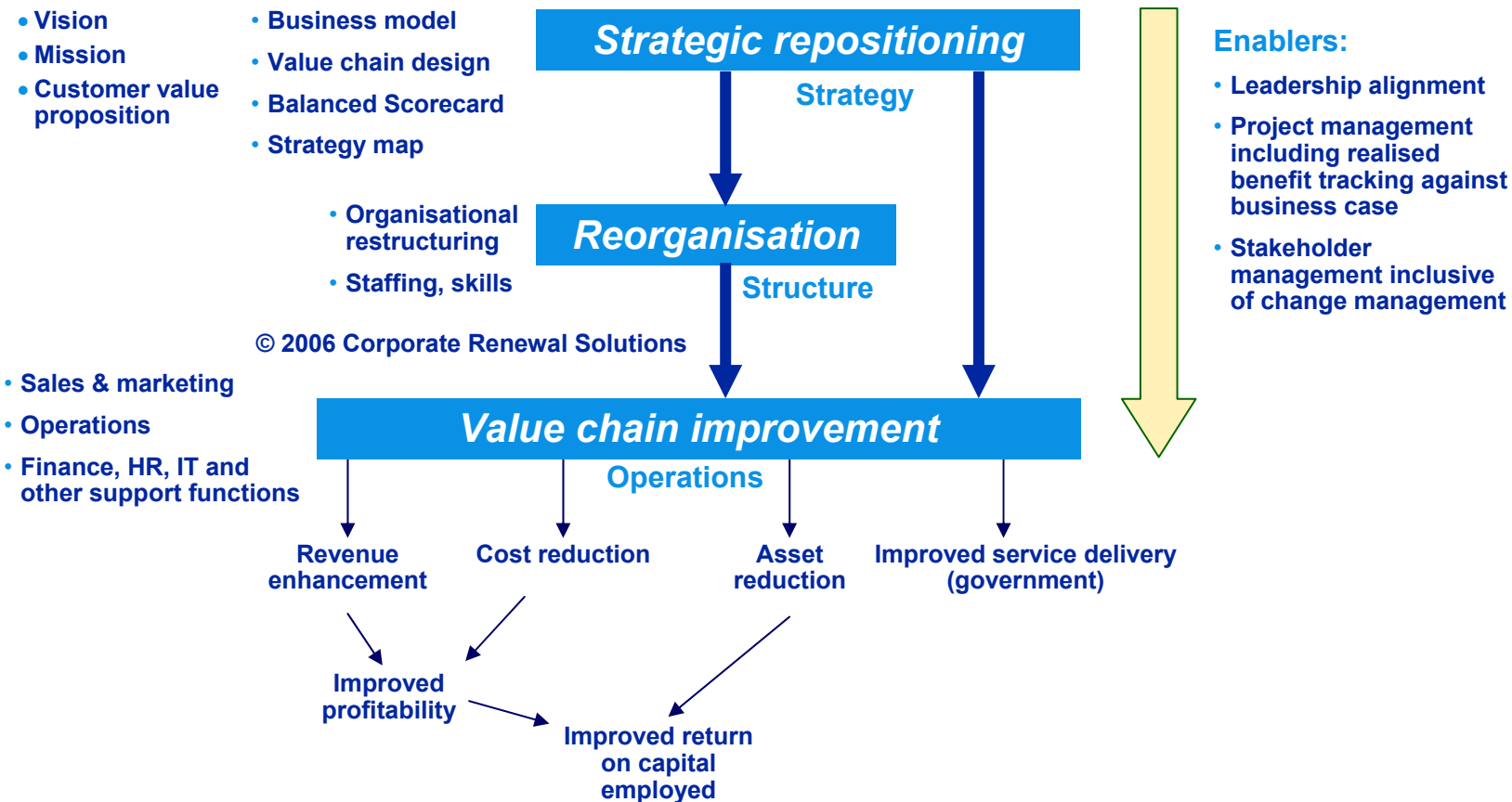
Turnaround strategy components:



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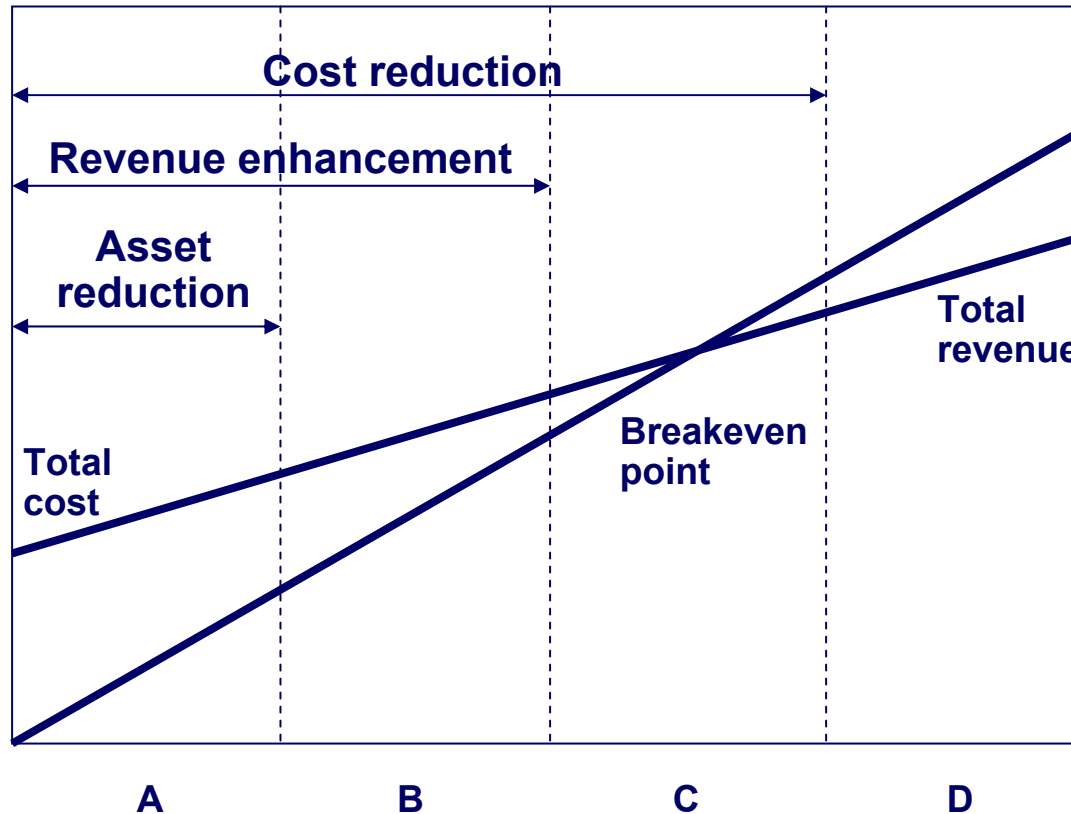
Fixing a distressed business has a number of dimensions

Generic turnaround strategies:



The severity of the crisis and funding available dictates operational turnaround strategies

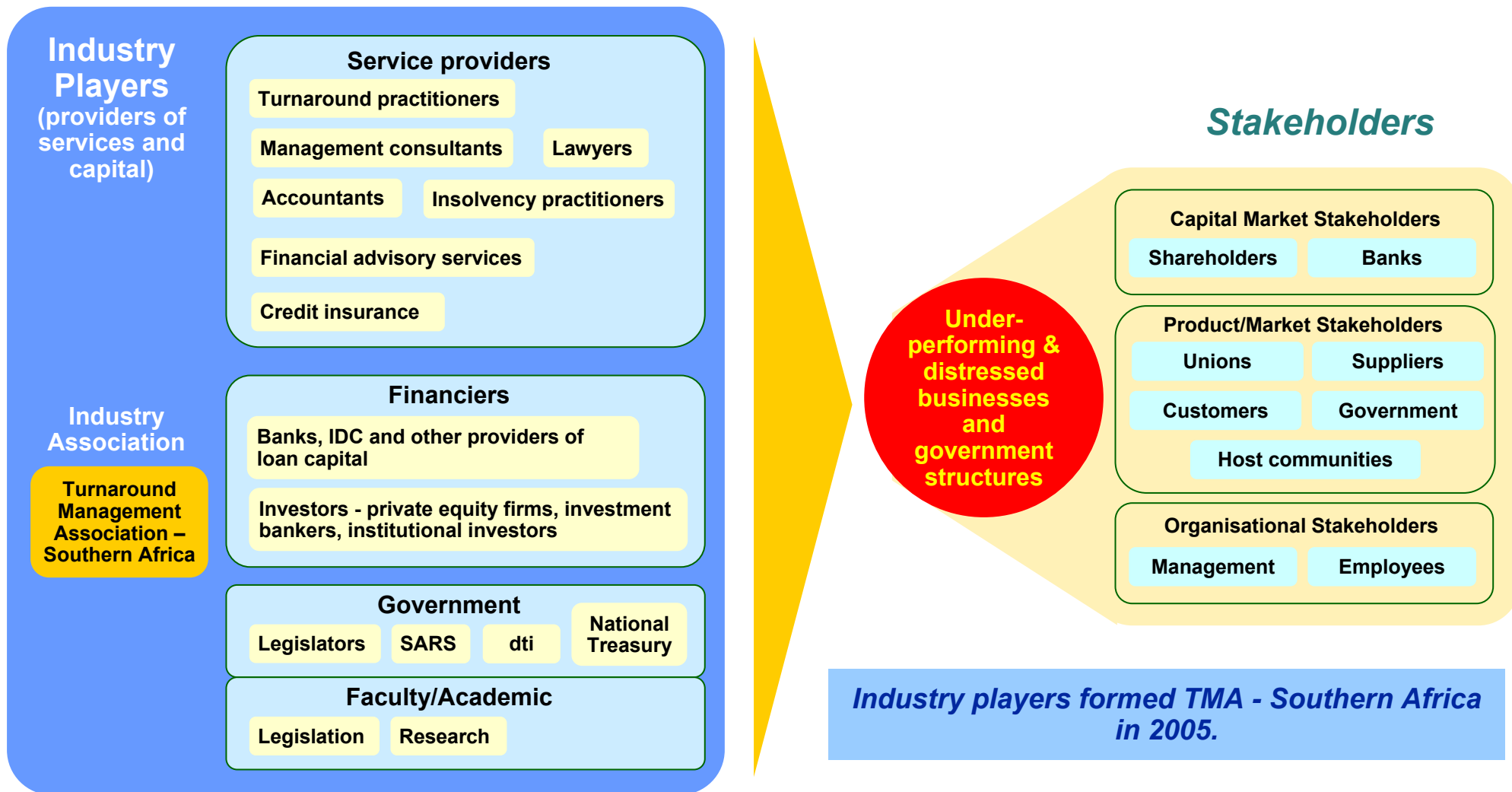
Hefer model:



The turnaround industry in South Africa:

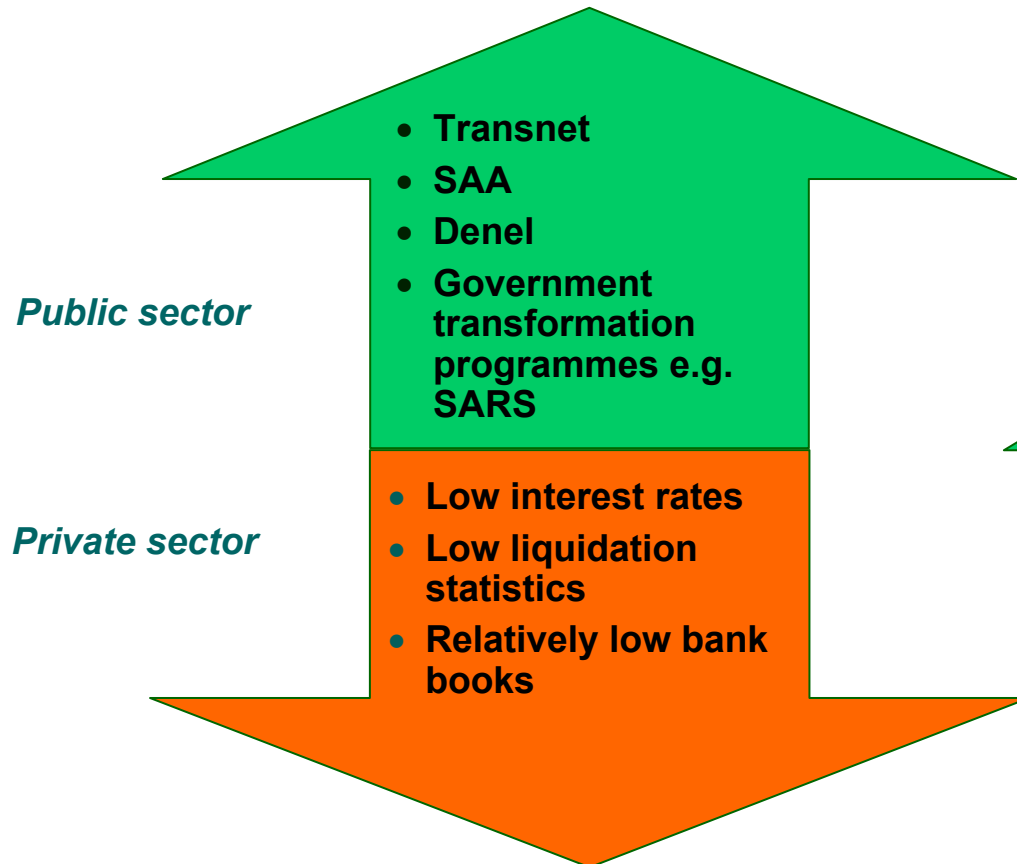
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The turnaround industry consists of turnaround professionals of various disciplines



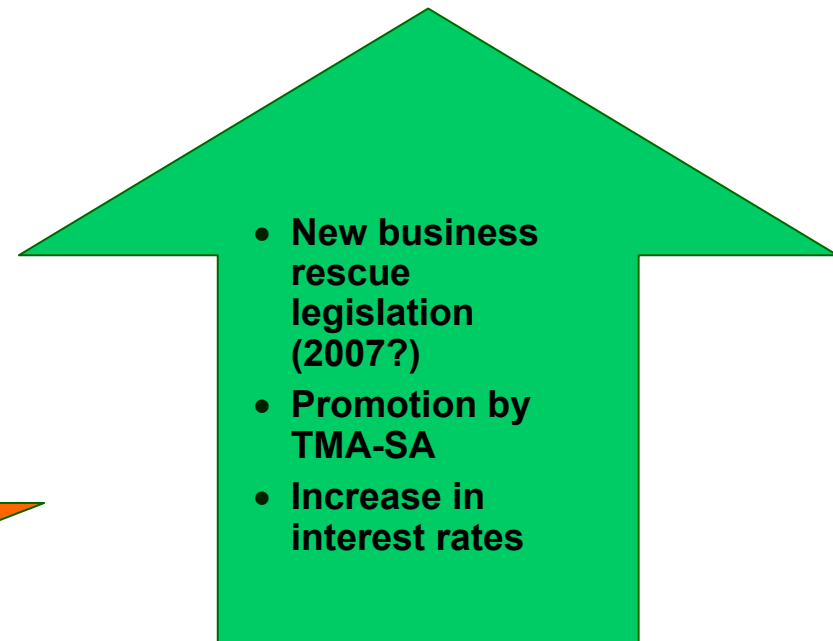
We believe that active industry associations and new business rescue legislation will boost the turnaround market

Present:



Future:

Higher private sector level of turnaround activity – 2007 onwards



But private sector turnaround activity will not return to the level of the nineties until the economy cools down and interest rates increase.

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A significant driving force is the newly formed Turnaround Management Association – Southern Africa

Political driving forces – 1:

Organised turnaround industry

- **Task Group for Organising the Turnaround and Business Rescue Industries:**
 - Active May – September 2004
 - Spawned ABASA and TMA
- **ABASA – Association of Business Administrators of South Africa:**
 - Formed in 2004 as in industry proposed business rescue regulatory body
 - Status: Registered, executive elected, awaiting government approval
- **Turnaround Management Association - Southern Africa**
 - Formed on 2005 to promote turnaround management in Southern Africa

See separate TMA-SA presentation.

Transformation of the liquidation industry will shape new business rescue legislation

Political driving forces – 2:

Transformation of the liquidation industry

- **Government is of the opinion that the liquidation industry:**
 - Should give way to the national interests of job preservation and business rescue
 - “And not merely to those of liquidators, secured creditors and their lawyers” (Enver Daniels – Justice Department”
- **Accordingly, government is planning to introduce reform:**
 - Will include “statutory regulation and the appointment of panels of turnaround specialists to try to save an ailing company rather than liquidate it”.
- **Ministerial Committee of Enquiry into the Liquidation Industry (2005):**
 - Prompted by corruption, mismanagement and lack of BEE
 - Led by advocates Seth Nthai and Lindiwe Nkosi-Thomas
 - Outcome unknown as yet

More about new business rescue legislation under Legal Driving Forces.

Government is involved with turnarounds via the Department of Labour, the NPI, Department of Trade and Industry and National Treasury

Political driving forces – 3:

Social Plan, SEDA and National Treasury

- **The Department of Labour's Social Plan allows for employers and workers to request assistance to prevent or minimise job losses when large-scale retrenchments are in the offing**
- **Social Plan's Technical Support Facility functions under the auspices of the National Productivity Institute (NPI)**
- **Private sector turnaround professionals are sponsored by NPI to conduct turnaround work**
- **More information: www.socialplan.co.za**
- **Department of Trade and Industry's Small Enterprise Development Agency (SEDA) now also looking at turnarounds**
- **National Treasury seeking information from TMA-SA amongst other things regarding tax legislation**

TMA-SA wishes to strengthen the industries ties with government and work towards alignment with and support of government initiatives.

Turnaround management benefit from rising performance standards and increasing world-wide acceptance

Economic driving forces – 1:

Rising performance standards

- **Increased incidence of shareholder activism and private sector shareholders becoming less tolerant of mediocre performance**
- **This trend extended itself to the public sector, where many turnaround programmes have been launched:**
 - South African Post Office - successful turnaround by Maanda Manyetse
 - Transnet - turnaround under way by Maria Ramos
 - SAA – turnaround under way by Khaya Ngqula
 - Denel – turnaround started by Victor Moshe, now under way by Shaun Liebenberg
 - SARS – business transformation under way by Pravin Govender

A lot of turnaround and business transformation activity is taking place at State Owned Enterprises and in government.

Turnaround funding is being re-examined

Economic driving forces – 2:

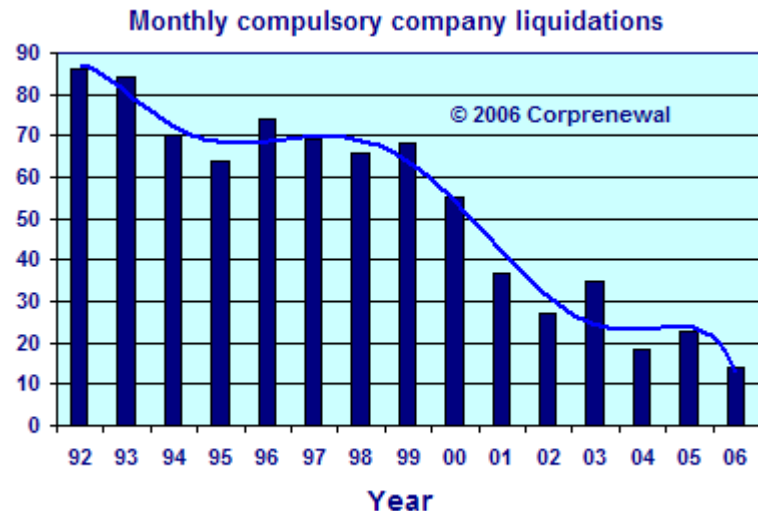
Turnaround funding

- **New business rescue legislation has prompted the banking and private equity fraternity to look at strengthening distressed debt transactions and turnaround funding**
- **Turnaround private equity funds to be formed?**
- **This driving force has not really emerged yet**

However, the private sector market for turnaround has declined significantly due to improved economic health

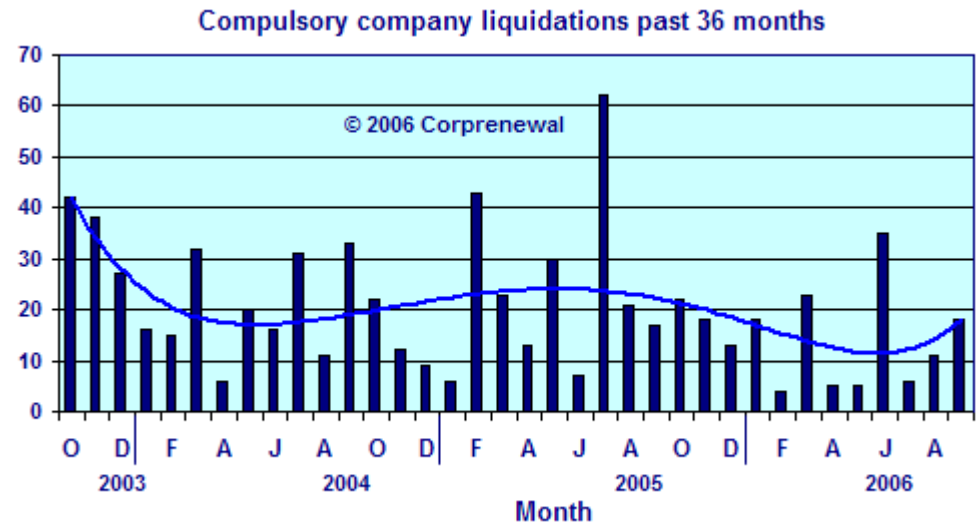
Economic driving forces – 3:

Economic indicators – low bankruptcy activity, but set to change



The 2006 figure is for 9 months to September

- **Downward trend Very little private sector turnaround activity**



- **No discernable short-term trend**
- **Expected to increase after June, August and October 2006 interest rate increases and expected more increases to come with a lagging effect**

Compulsory company liquidations represent a lagging indicator of the potential market for turnaround.

Voluntarily company liquidations are disregarded as these are not necessarily as a consequence of financial distress.

Job preservation is an important objective of new business rescue legislation

Social driving forces:

Unemployment

- **38,8% unemployment rate (expanded definition i.e. including the unemployed not actively looking for work) (Stats released September 2005)**
- **26,7% official unemployment rate (only active job seekers)**
- **As a result, a business rescue culture is developing amongst distressed businesses' lenders:**
 - Rescue rather than liquidate
 - Banking Council press releases pledging support

4 out of 10 South Africans are unemployed.

Hence government intervention in the liquidations industry and new business rescue legislation.

Turnaround funding is being re-examined, and formal turnaround education is strengthening

Technological driving forces – 1:

Formal turnaround education

- **Certified Turnaround Professional (CTP) exam planned (associated with TMA-SA)**
- **ABASA admission exam planned (may be the same as the CTP exam)**
- **Turnaround management courses planned in association with ICSA at universities to prepare students for the CTP exam**
- **Turnaround management taught at Rhodes University as part of Strategic Management course (Professor Neil Harvey)**

Industry is more and more networking and educating through conferences, publications and web sites

Technological driving forces – 2:

Turnaround lectures conferences and publications

- **This annual 5-day conference on managing a turnaround**
- **Monthly lecture series presented by TMA-SA at Wits Business School**
- **Turnaround series in Professional Management Review**
- **Annual TMA convention in USA (900 delegates) on turnaround management**

Turnaround industry web sites

- **TMA-SA web site at www.tma-sa.com**
- **“Turnaround Industry in SA” section on the Turnaround Solutions web site since April 2004 at www.turnaround-sa.com**
- **“Turnaround Industry SA” blog at <http://turnaround-sa.blogspot.com>**
- **These deal with turnaround news, events, opinions, links, references, industry info, industry associations; new business rescue legislation info; liquidation statistics and news**

New business rescue legislation is expected to become the most important future driving force of the industry

Legal driving forces:

New business rescue legislation

- **Government places a high premium on job preservation and saving businesses**
- **Hence new draft business rescue legislation as Chapter 6 in the new Companies Act to replace judicial management**
- **Will allow for turnaround to take place within a legislative framework for the first time**
- **The debtor-friendly nature of the draft legislation may change the way banks lend out money i.e. make lending conditions more stringent**

See section on business rescue for more information.

The turnaround industry in South Africa:

- Turnaround situations
- Causes of distress
- Turnaround strategies
- Turnaround industry in South Africa
- Turnaround industry driving forces
- Turnaround industry constraints
- Government interventions

Timing of turnaround intervention, and lack of finance represent the two biggest constraints to growing the turnaround industry

<i>Constraint</i>	<i>Resolvable?</i>
<p><i>Long lead time before a turnaround is triggered:</i></p> <ul style="list-style-type: none"> • Boards and management tend to wait until a crisis has developed (management denial) • When banks intervene with workout action, it is normally too late too • Turnaround viability is low once a business has reached the Failing Zone in terms of the Z-Score 	<ul style="list-style-type: none"> • Education via industry associations and conferences will help • New business rescue legislation may bring heavier penalties for directors trading under insolvent conditions
<p><i>Lack of turnaround equity finance:</i></p> <ul style="list-style-type: none"> • No specialist turnaround private equity firm in SA • Those that do finance turnarounds tend to focus on underperforming rather than distressed companies • Lead-time for due diligences tends to be too long for a company requiring urgent refinancing 	<ul style="list-style-type: none"> • Government-sponsored business rescue fund? • New private sector initiatives to start turnaround private equity?

In addition, there is a number of statutory constraints

<i>Constraint</i>	<i>Resolvable?</i>
<p><i>Antiquated insolvency legislation:</i></p> <ul style="list-style-type: none"> • Judicial management a failure • Insolvency regulation scattered across the Companies Act, the Insolvency Act and the Close Corporations Act 	<p>To be addressed through new business rescue legislation (Chapter 6 of the new Companies Act)</p>
<p><i>Stringent labour legislation:</i></p> <ul style="list-style-type: none"> • Recent amendments to the Insolvency Act reiterate government's commitment to saving jobs and the protection of employees when a company experiences financial difficulties • For instance, if a distressed business is sold, all employees from part of the deal 	<p>New business rescue legislation not expected to lead to changes in the LRA</p>

Statutory constraints (continued)

<i>Constraint</i>	<i>Resolvable?</i>
<p><i>SARS (SA Revenue Services) policy:</i></p> <ul style="list-style-type: none"> • Ring fenced assessed losses cannot be transferred as overseas • VAT during restructurings e.g. Section 311 often kills the transaction: <ul style="list-style-type: none"> – But advanced tax ruling is a positive step • Late payment VAT penalties for distressed business often delivers the killer blow • SARS a preferred creditor: <ul style="list-style-type: none"> – Contrary to the clear international trend toward levelling the playing field between governmental creditors and ordinary creditors • These are as a stumbling block preventing entrepreneurs and financiers stepping forward to participate in business rescue 	<p>National Treasury taking note of implications</p>

Lastly, there is a constraint relating to size of business

<i>Constraint</i>	<i>Resolvable?</i>
<p><i>Small businesses:</i></p> <ul style="list-style-type: none">• Do not have the resources and slack to withstand distress as well as larger businesses	Special tax breaks?

The turnaround industry in South Africa:

- Turnaround situations
- Causes of distress
- Turnaround strategies
- Turnaround industry in South Africa
- Turnaround industry driving forces
- Turnaround industry constraints
- **Government interventions**

Government can help with business rescue in many ways

New business rescue legislation:

- **Forming a regulatory body for business rescue to deal with supervisor admission requirements, certification and disciplinary issues**
 - Industry has formed the (dormant and now wrongly named) Association of Business Administrators of South Africa in anticipation – TMA-SA can help integrate the affairs of government and industry
- **Making use of TMA-SA to make new business rescue legislation work in practice:**
 - CTP (Certified Turnaround Profession) certification in South Africa
 - TMA-SA can help to arrange industry conferences to ensure buy-in and ownership from industry

New Companies Act:

- **Consider heavier penalties for directors trading recklessly:**
 - This is reportedly included in the new Companies Act already

Business rescue funding:

- **Consider a government-funded turnaround private equity fund to finance business rescue**
 - Through National Empowerment Fund?

Government can help with business rescue in many ways

Labour legislation:

- **The requirement to take over the employees remains a major impediment to new ownership (and thereby funding) of a distressed business**

Taxation – reassess impediments to business rescue:

- **Consider allowing ring fenced assessed losses to be transferred as overseas**
- **Assess ways of dealing with VAT during restructurings e.g. Section 311**
- **Assess how to deal with late payment VAT penalties for distressed business**
- **Re-assess SARS being a preferred creditor – level the playing field as overseas**

TMA-SA offers its support, help and advice to government when asked and when required.

While this presentation addressed issues at a high level, TMA-SA offers to research and compile more detailed information if needed.

Questions?



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