# WORK-OUTS — THE CHALLENGES OF THE 90S


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No, I will not tell you what the strike price on Woolworths will be!

I start on a premise with work-outs that you only embark on work-outs where there is value that needs to be realised. If it is just a pile of assets that you are dealing with that you can take down to the local auctioneer, get on and do it. I also start from the basis that standing here in front of you as third speaker is fairly terrorising - I think I am the only corporate in the room and I feel as if you are about to scheme me, manage me, or administer me in about a million different ways and you also act for the eighty-four happy chappies who are still the lenders to Adsteam - so please be kind!

My experience of work-outs has been on transactions in a range from as small as $30 million to the current $5 or $6 billion, and a number of ones in between. What I want to talk to you about is what I see as the seven stages of a work-out. This is a little like the seven stages of death and dying, but hopefully with a slightly happier ending.

The seven stages as I see them are as follows. The first stage is the denial, despair and self delusion stage. The second stage is the lemming recognition, attempted escape and entrapment stage. The third stage is the indecision and internecine argument stage which often overlaps with the second stage. The fourth stage is acceptance. The fifth is the hiatus. The sixth is the real deal. And finally, the seventh is what I call the three Vs of a work-out.

Dealing with the first stage - denial, despair and self delusion - David touched on this, this is where management and the lenders think: 'it is only a glitch, it is not material, it will go away, inflation will dig us out of it, the risk is greater than it was before, so we will forget the difference between principal and interest and we will increase the fees and the margin.' At that stage of the game you go on to commission a report by management to find out what it is that you really lent to in the first place. You get the report back and you do not like it, so you go and commission a report by the auditors to find out where the cash is going. You get that report back and you do not like it either. And then you go and get some external experts to do some work so that they can try and figure out just what it is that you are dealing with.

The lending officer, having got to that stage, then fronts up to the credit committee and that is the despair stage. But there is hope because they look at their exposure and they go: 'gee, it is mainly swaps and derivatives and the lawyers have not figured out that they are really loans by another name, so we will escape because we will not get schemed in some way, shape or form.' But the world has caught up with that. Then they think: 'well no one else has really figured out that there is a problem here and we have a really terrific relationship with this borrower, so we will go along and get ourselves paid out.' And they arrive and find that six people have already headed for the door and everybody else is now discovering there is a problem.

So then they have a look at their documentation and remember that they competed like crazy on price, had nowhere to go, so then they competed on the documents and you guys ripped your hair out because they gave away too much on the primary loan documentation, so then they go to the security cupboard - the relief of all besieged lenders, and they pull out the unsigned photocopied letter of comfort from the shelf holding company!

Now the result of this stage, which often takes quite a while, is that value is eroding and there is no control on the business.

You then hit the lemming recognition and attempted escape and entrapment stage. This is where some of the lenders figure out that they are really in a bad place compared to some of the other lenders and they go: 'Oh look, let us be democratic about this and put it all in one pot and we will all share from that pot.' 'Not on your Nelly' say the guys who have got security down against the cashflows of the businesses. In Adsteam we found out that there were twenty-three debt cells, that was twenty-three different sorts of claims that were genuinely unique in nature.

So then the small lenders do the run for the door and they say that there will be one big bank out there that will have a bag of cash, they will pay us out, or there will be a debt buyback, or something else. The way that you have to fix those is as described by my predecessors and that is just say we will scheme you and you just keep on saying we will scheme you, here are the documents, here is the plan for the work-out and here is the scheme document which you cannot change.

The interim result is that the value is still eroding and there are still no controls and more time has gone by. This is where you guys get your big play on the ball because then you have the contractual moratorium - and that is an absolute doosey. You get to push the button on the word processor and pull off the most draconian loan agreement that you can possibly think of and then you make it worse. It is plopped on the table in front of the directors, and of course the lenders do not want to be directors, but it plops on the table in front of the directors and they get told: sign this or Crawford is going to be sitting in your chair.

The result of this is that the value is still eroding, there is an immediate breach of the moratorium as the borrower walks out the door, and there are still no real controls on the business, but there are endless waivers, and that keeps everybody busy.

You then hit the indecision and internecine argument stage. Now the moratorium is in place the lenders come up to each other (this is the macho stage of mine is bigger, longer and better than yours) and they find all these other documents. Some of them are good and some are not good, so they go off and have a battle in the corner, they threaten to sue each other, the borrower is saying: you guys all represented you would extend the loan and you have broken that agreement, we are going to do a section 52 on you. And so everyone threatens to go to court. Happily at this stage you generally get a committee of lenders who get in place and a chairman, and this is a very good idea. You call for some more reports. You get accountants' reports that show cashflows into the future, you may get a valuation report and so forth, and that gives you the template to go forward.

The inmates are still in charge of the asylum, so you have got a real problem there, and you are asking them to do a management plan for the way forward. You had better get them some help or else they are going to go back to the head office and pull out the plan that they had three years ago and say: 'here it is - the brand new plan,' because they are in the business of buying time because they have equity funds at debt rates instead of equity rates. The result of this stage of the process is that the value of the business continues to erode and there are still no controls in place.

You then hit acceptance. At acceptance, that is the stage where you get the plan. The plan should say that you will give time to the businesses to help get the debt back for the borrowers. You should have a brand new set of documents, junk everything that went before it, start from scratch. I hate to say it Tom, but I totally disagree with you - you should have much more relaxed covenants, events of default and milestones. If possible totally avoid amortisation schedules because that is telescoping what you are doing. The reason I say that is the other day I was listening to Hugh McKay, the social researcher, he said: 'how often do you hear a parent say to little Johnny, "little Johnny, if I have told you once, I have told you a thousand times, wipe your feet on the mat before you come in the door." And what do they do? They turn around and they say exactly that to the child again. It is a failed strategy, but they are going to keep on trying.' The covenants have already failed. They were the bullets that gave you the chance to pull the trigger. You do not need them any more. You are in trigger pulling mode. So if you constrict the business, you are going to kill it. I am happy to say that in the largest work-out that I have been involved in which is obviously the Adsteam one, the lenders took a very sensible and pragmatic approach to this issue.

David has dealt with directors' duties and the finding of religion which invariably happens. People suddenly get strong who have been as weak as anything. Also face the fact that you are going to have to prefer the trade creditors or else you are not going to have a business to sell, or just ring up the auctioneer and take the assets out the door. If you do not prefer the trade you are not going to have any supply, so get over that one and get on with it. When you restructure the debt do not allow secondary trading in the debt because you will get some bandit from the States or Europe who will come and buy some of the secondary debt at a low price and then have double the votes that everybody else has in meetings. - The plan should cover all of this I should say. - Keep the business alive by allowing working capital into the business and funds for capital expenditure if necessary. And face the fact that you will have to prefer that over the affected debt if anyone is going to put the money in.

And finally at that stage, deal with the fact that a whole chunk of this debt is now equity, and recognise that, and because of the crazy tax laws that we have got in this world, come up with some weird instrument like a PCORN or a CRUST to get tax symmetry and give the lenders a chance to get that money back if the sun comes a long way up in the sky later on.

At the end of the acceptance stage the result is that the plan leaks, everything does. If it is a good plan, that will help stabilise the business. If it is a lousy plan, it will continue to damage the business. And there are still no controls on the business because you have not documented them.

So then you get to the hiatus stage, and that is the documentation of plan, the lender approval process, and the company approval process if it is a public company. Again you guys get a play on the ball here because there are the internal company lawyers, there are their external lawyers, there are the internal bank lawyers, and there are the external bank lawyers, and you look at the plan and you go: 'they have got it wrong!' And you guys decide to redesign the plan that a bunch of people commercially have been trying to put together for weeks, months, perhaps six months. That will lead to more delays as that gets fought backwards and forwards. There are generally lower level people in the organisations dealing with the documentation, so you have got to fight it back up to the top of the organisations again to get the sensible decisions made. You get a lack of focus by all parties during that process even though the deal has been done. The directors are still looking for protection - the old directors. And you guys want security over everything, so you are making donations to the public purse as David said, and I think that is just a total waste of the banks', the other creditors' and the shareholders' money.

So at the end of the hiatus stage, what have you got? The value has possibly stopped eroding and has stabilised and as the documents are signed, you have got some controls on the business because you will have built in some sort of annual budget and business plan process which is your real protection since you are going to inject new management and new directors.

The next stage is the real deal after you have the documented plan. Make sure everyone puts this one on their desk rather than under it. Have some sort of compliance system with it. At this stage with the real deal you will be able to get new board members and some new management. There is still a lot of resentment between the lending group and the company even though there are new folks in place because the lenders are in pain and they want to hit something, but they know if they hit it too hard they are going to break it and lose money. But they do have trouble getting over that residual resentment.

Make sure in the loan documentation that you have the ability for the lender or preferably a representative of the lenders to attend board meetings and management meetings. You can have some remarkably fast board meetings if the lenders are allowed to attend - they can take about thirty-five seconds. So you need to be where the action is. And bearing in mind lenders still do not want to be directors, right. You know that. They have got this shadow director problem and we known they do not want to be lenders because you guys draft clauses in the documents that says the directors and the borrower acknowledge that the lenders are not directors, which is absolute proof in my mind that they are.

And now you get the dash for freedom. The management of the businesses involved in the process realise that they are no longer being viewed as a pile of assets being dispatched to the auctioneer, but they are going to be sold or floated and so they get an attack of independence and the conflict issue then arises between them wanting to go down one sale route and in the interests of everybody you may want to sell them in another way.

The result at the end of the real deal stage is that the value erosion should diminish, and I think there is plenty of evidence that that is the case. You have to deal with the conflict issue, but it is a good conflict issue to deal with because some of the people in the subsidiaries are feeling good about themselves again, good about their businesses and start thinking in a forward-thinking fashion again. Staff morale goes up and supplier morale goes up. It is at this stage that you really need to step back and think about the very high quality of loan recoveries where the banks have provided properly. If they can recover 10 or 15 or 20 million dollars more than they had provided in the loan, that is very high quality stuff that goes straight to their bottom lines. So it is a case of not trashing the stock and throwing it out straight away, not going into the immediate sale process for every asset and getting it done in six months when it should take two or three years, but being prepared to invest in the escape for the businesses and doing it sensibly. You get very high quality results out of it if you have high quality people from the banks involved, if you have new management and new directors in the client, and good advisers.

So that brings me to the three Vs of a work-out. The three Vs of a work-out to me are value, value and value. At every stage everybody involved should say: 'What is this decision doing to the underlying value of the businesses?'. It is not about retribution and revenge, it is rather about rehabilitation and recoveries. It is not death by documentation, it is not death by strangulation, it is not death by telescoping the asset sales to the market. But rather it is stabilisation, sensible behaviour, sales of assets at appropriate times, and all of this leads to recoveries, job creation and a lower burden on the individual taxpayer's purse.

I do not know enough about the new legislation to know whether we will move away from work-outs. I am very much in favour of a work-out in the old environment. I am trying to come to grips with the new legislation. I think work-outs can be made to work. The time that is involved in putting them together needs to be shortened so that the underlying businesses are not damaged. And that to me is the challenge of the 90s.