Workouts

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Introduction

This paper draws on our experience both in Australia and South East Asia in the recent past.

While the first part of the paper deals with the key questions working an Investigating accountant ("I/A") assignment the second provides a study in contrasts being our involvement in two of the largest restructurings in Asia in recent years being Asia Paper Pulp in Indonesia and Thai Petrochemicals in Thailand.

The function and outcome of an I/A review is usually crucial to the success of any workout. The completion of an I/A review can be a bridge between a borrower and financiers / financing syndicate, to provide a critique of the issues across the borrower's and hence financiers' risk profile. In an ideal situation the role operates as a genuine tripartite relationship and the success of any review will be dependant upon the level of trust which exists among the three parties to seek an equitable outcome.

Because of the disparate interests involved, the I/A role can also be a "high wire act" in terms of assessing the risk involved and balancing them in the appropriate way given the sometimes competing interests of various stakeholders.

In any I/A review the four most important questions to be dealt with are:

- Who should make the appointment – borrower or financier / syndicate?
- What is the job?

- How do we go about the review and identification of the risks facing the borrower and financier?
- What are the risks for the financier and the I/A as a consequence of the I/A review?

1. WHO MAKES THE APPOINTMENT – BORROWER OR FINANCIER / SYNDICATE?

Risks of Borrower Appointment

1.1 Potential Constraints and Information flow to I/A

Constraints on the information flow more readily arise from the borrower rather than a financier. The reasons for this range from deliberate obstruction by the borrower's hierarchy, desire for confidentiality which may limit the number of borrower personnel involved or just a perceived lack of urgency if the review is initiated internally rather than by the financier.

1.2 Potential constraints on conclusion

Many I/A reviews include a requirement for honest and direct assessment of borrower's management and this will be more difficult if the borrower is the appointor. There is also greater potential for the scope of the review to be constrained from covering significant business issues, and areas of specific segment performance.

1.3 Potential conflict in taking later appointment

If an I/A has acted in an advisory role for a borrower, it may still be possible to accept a formal insolvency appointment, if that is required, provided the advisory role is for less than a two month period.

In reality these ethical guidelines are the maximum and any practitioner needs to consider any potential for actual perceived conflict of interest if an engagement has been accepted from a borrower.

1.4 I/A and Financier access

There will be a crucial need for unlimited and unsupervised two way access between the I/A and the financier. If this is properly structured and documented in the engagement, some of the potential constraints identified above can be mitigated.

Aspects to an Appointment by Financier

1.5 Better informational flow

A financier engagement generally provides for a better information flow because of the greater imperative that stems from the source of appointment.

1.6 Potential conflict

There is less prospect for potential conflict in later appointments (although the risks may still be substantial as discussed later in this paper). As the role is not an engagement by a borrower, the potential for conflict on a later receiver appointment is minimized. Potential for appointment as voluntary administrator also has a reduced prospect of conflict.

1.7 Clarity of role

While a borrower has the capacity to obtain significant benefits from the I/A review, the value to financiers is enhanced if they conduct the appointment.

It is highly desirable that the borrower acknowledges the scope of the review and this should be clearly documented.

1.8 Factual checking by borrower

The borrower should have relevant sections of a draft report made available for checking of factual information – this saves time, money and may also save relationships. It is desirable to ensure that a proper timetable is agreed for dispatch of draft information and obtaining responses from the borrower, to allow the timely completion of the report.

2. WHAT IS THE JOB?

It is essential that the nature of the assignment be determined by an agreed scope.

2.1 Three way clarity

Having a completely open, agreed scope, assists the tripartite relationship and facilitates a common level of understanding of what is required and what the outcome will be. In some cases, certain sections of the review might remain confidential between the I/A and the financier. When this occurs it is preferable that the existence of these confidential components be disclosed, even if the content will not be made available to the borrower.

2.2 Documentation of the scope

It is essential that the initial scope and any agreed variation are fully documented for the usual reasons. This is all the more important in dynamics in syndicate situations, where individual financier's positions and understanding of the reasons and outcomes of the review may change. The agendas of borrowers may be similarly dynamic.

3. HOW DO WE GO ABOUT IT?

In broad terms, the review usually covers one or more of:

- assessment of the present situation;
- assessment of proposals to change the business;
- monitoring of proposed changes.

3.1 Assessment of present situation

This part of a review is in turn usually broken down into:

- review of current activities;
- assessment of the financier's security position on "going concern" and "ceased trading basis".

3.2.1 Review of current trading

- Business Plan

  Review of current business plan and its elements is the initial starting point. This would include a review of material adverse financial trends, cashflow consequences, market conditions and the level of "reality" built into the forecasts.

- Financial Analysis

  This provides a snap shot of the outcomes of recent trading patterns. It would include the familiar trend and ratio analysis and financial bench marking.

- Observation of the processes in business operations.

It is necessary to explore beneath the financial outcomes and examine the processes used in the business. These processes can be those in financial reporting systems or in other facets of the business such as production, logistics, HR management and corporate governance.

- Major business risks

- Looking outside the business, it is necessary to understand who has the leverage with the borrower and visa versa – this in turn has a major impact on the adequacy of the existing strategy and processes.

- Impact on financier

  This analysis will help draw together the key risks in the current business activities for the borrower and hence the underlying risks facing the financier in its exposure.

3.1.2 Assessment of security position

This is typically done on "Going Concern" and "Cease Trading" bases for means of comparison and usually covers the following areas.

3.1.3 Real Property Assets

Aside from a property valuation, consideration is required on how particular real property assets remain critical to the borrower's activities. It is usual for "alternate use" to be considered, together with risks arising under environmental / occupational health and safety legislation or requirements.

- Leaseholds

  The value of any leaseholds requires assessment according to the particular lease criteria and available market. For a "Cease Trading" scenario, the susceptibility of the leaseholds to loss of rights in insolvency needs to be considered. Typically, a voluntary administration will provide superior breathing space and flexibility than a receivership.

- Plant and Equipment

  Again valuations may be obtained and the review will typically examine whether the equipment is surplus to needs, providing an opportunity for debt reduction from sale, or potential reallocation of individual business capacities. For Manufacturing and Resource operations particularly, OH&S issues surrounding plant and its potential sale usually require special consideration.

- Stock / work in progress

  Retention of title issues usually require significant investigation for businesses carrying trading stock. For larger scale items or borrower's who supply stock into longer term contracts, the pattern for making and receiving progress claims will also be critical.

The remaining key issue will be recoverability of stock or work in progress levels in either of the "Going Concern" or "Ceased Trading" scenarios. Where a borrower may continue to trade even in insolvency, the capacity for continued access to supply will be important.

- Receivables

The quality and collectibility of receivables is a crucial issue and will be impacted by potential for claims / credit. Further complications will usually arise in assessment where progress claims have been made.

- Employee entitlements

Apart from the quantum of leave and potential notice / redundancy requirements, the prospect of superannuation contributions will also impact the assessment of employee priorities.

There are also instances where financiers are unaware of changes to enterprise bargaining agreements which usually result in enhanced employee entitlements at the expense of secured financiers.

In more complex corporate structures it is common for a variety of historical or other reasons, for employees to be contracted to particular members of a borrower group regardless of the domicile of floating charge assets which might support their entitlements in an insolvency. Employee unions are increasingly aware of this aspect and will also increasingly seek to have their employees "grouped" to the most optimal spot for recovery of entitlements in an insolvency. This might be achieved through specific legal action, negotiation with the company or with an administrator / receiver if the issue arises during an insolvency.

➢ Trade creditors

Apart from the expected financial analysis and review of aging, it is necessary to look at the dominance and leverage available to particular creditors in both the "Going Concern" and "Cease Trading" environments.

A review of the currency of tax payments is also required covering income tax, PAYG, GST, FBT, payroll tax and land taxes and rates which attach to properties as statutory priorities.

3.2 Commentary on proposed strategies

The specific work to properly assess the likely outcome of proposed strategies is usually as diverse as those strategies themselves. However the I/A review usually involves the following processes.

- Testing key assumptions underlying changes in business activities, such as business mix, generation of review products or services or changes to the cost structure.

- Assessment of reliance on and the relationship with key customers and suppliers during the process of the change.

- Utilising other experts as necessary for market, technical or other input. It is usually more effective to have a choice of external parties to call upon for each area of expertise.

- The impact on other business relationships needs to be assessed such as those with unions and broader business alliances / partnerships.

- The proposed timeframes for change need to be assessed as to whether they are achievable.

- It will be necessary to "stress test" the cash flow projections which translate the proposals to a financial outcome. The changes to particular cash flow parameters should emerge from the review completed under the processes outlined above.

- The last stage of the commentary is usually to recommend appropriate milestones and benchmarks. These might be timeframes, particular financial results or completion of relevant business objectives.

3.3 Monitoring

As for the commentary on proposed strategies, the need and extent of monitoring will depend on the individual situation but generally has some or all of four broad areas:

- Assessment / reporting of operations performance. This may purely rest with analysis of financial information or may cover specific operational parameters.

- Identify and analyse changes in key business risks or emerging trends in the business. Consideration will usually be required of the impact of these trends and possibly a reassessment of the "stress testing" completed for the initial strategy review.

- It may be necessary to re-evaluate the strategies and recommend changes to the benchmarks or milestones initially set.

- Monitoring may also include an assessment or reporting of progress on asset sales, where these are a key feature of the proposed strategy.

4 WHAT ARE THE RISKS AS A CONSEQUENCE OF THE REVIEW?

Most obviously the risks for the I/A reviewer and the financiers rest in the assessment being wrong and the consequent decisions on the assessment also being wrong. This risk can run two ways:

- either to under-estimate risk of financial loss or troubled conduct of a borrower; or
- to over-estimate the risks and consequently have a deterioration in or loss of the relationship.

Even if the risk assessment by the I/A and financier is correct, there are a number of ways that the risks for them can be pushed to either end of a "risk spectrum". Below are some typical examples of variables in an I/A appointment which can impact the risk outcome.

4.1 Assessment of position as assessment of strategy

Review of current position will provide an analysis based on largely factual data which provides the financier with a valuable snap shot of the borrower's present position.

A higher risk emerges for both the I/A and the financier of "shadow directorship" issue, where the reviewer is involved in the strategy assessment and developing proposals or positions based on that assessment. Adopting this role usually means the financiers are more proactive in setting the borrower's business perimeters which can be interpreted in playing a key role in business management.

4.2 Setting milestones

In a similar vein, there is a higher risk attaching to more prescriptive recommendation for the business future and application of milestones, benchmarks or facility covenants than if fewer constraints are put around the borrower's future business activities or outcomes.

4.3 Industry specific factors

There is a higher risk in some particular industry categories through legislative risk or through the characteristics of the borrower's business activities. For example, environmental and occupational health and safety risk issues are typically more prevalent in extractive or manufacturing industries than other types of operation.

4.4 Insolvency Issues

For the I/A there is a stronger potential for conflict if recommendations and opinions are made on insolvency issues and a later administration / liquidation needs to examine the same issue. This potential for conflict could easily preclude the I/A taking on a formal appointment, which might otherwise be a desirable outcome for reasons of either cost or expertise.

4.5 Monitoring Asset Sales

There is great risk of "shadow director" argument if the I/A and financiers are closer to asset sales and are providing more prescriptive monitoring or control of them.

4.6 Confidential Information

The financiers regularly face risks in distressed debt or open market trading in ensuring that other limbs of their own organisation have appropriate "Chinese walls" where one part of the financier has access to information which is not generally available to the market.

4.7 New Money

Particular risks can arise for both the I/A and financiers where ongoing or changed funding arrangement may be viewed adversely under Section 596 of the Corporations Act. Examples may be administrator funding or debt factoring, where the funding and its structure may be deemed to have even the partial intent of diminishing assets available to satisfy employee priorities.

4.8 Listed Borrowers

There are particular risks on the need for market disclosure for listed borrowers and those risks in turn may translate to the I/A or financiers. There are a range of disclosure issues potentially triggered by changes to lending agreements, defaults or waivers of events which would otherwise cause defaults. The financiers may also be exposed to the later argument that failure to waive a default constricted a borrower's capacity to raise funds and potentially resolve other financing problems.

4.9 Liquidation occurring during a Workout

Where a liquidation occurs during the workout process, the risks can be grouped into three categories:

- because the solvency of the borrower has crossed into an irredeemable position, the prospects for the work out also have a high probability of failing. The exceptions might arise if the business activities can be transferred to another legal entity and the myriad of legal & commercial issues covered in the process. These issues particularly include the changes to the business triggered by the event of an insolvency.

- the liquidator has certain statutory and investigative functions which will, in many instances, be disparate to the objectives of the workout. A level of compatibility would need to be found between the competing priorities until the position could be resolved.

- the Directors will have other obligations and concerns, especially if there is exposure to valid claims of insolvent trading.

- the financiers and their advisors will have the issues of "shadow directorships " brought closer and this may influence their approach to continuing the workout process.

5. OUR ASIAN EXPERIENCE

Different Jurisdictions

Different jurisdictions present their own business and cultural challenges. Whilst the focus has largely been on workouts in an Australian and New Zealand context, a significant part of our restructuring practice in the last two years has been not only in these jurisdictions but throughout Asia.

Notably they have included Thai Petrochemical on behalf of a group of approximately 150 financial creditors owed US$3.7bn from 40 countries; Asia Paper Pulp Group that produces approximately 5% of the worlds supply of pulp and paper operating in Indonesia and China, employing 300,000 people with turnover of approximately US$4bn and debt of approximately US$14bn owed to 200 banks from about 30 countries. We have recently also been retained in a well publicised Korean restructure called SK Global and in the last twelve months participated in the successful Australasian restructuring arising from the collapse of one of the largest US based telecommunications companies.

Asian Restructuring

I felt it was helpful that in the context of what had already been discussed, I provide you with some insights and flavour as to our Asian restructuring experience.

In short, it provides for a study in contrasts.

This arises as a consequence of:

- obvious cultural differences;
- vastly different legal jurisdictions;
- indifference to the use of formal insolvency procedures;
- questionable political desire or will to support enforcement for nationalistic reasons.

5.1 Thailand and Indonesia

In Thailand our experience with TPI can be best described as very challenging.

In Thailand the attitude of corporates to corporate governance has in the past been poor. It is however improving.

As a result, publicly available financial information is not a very reliable method for a lender to monitor financial performance of the borrower.

Overlay this with a reluctance to finance investments through equity as this causes dilution and this results in highly geared enterprises who raise funds through debt.

Add into the mix rampant creative accounting and a general reluctance to publicise any information for "face" saving reasons, it is easy to see how lenders may be surprised when a borrower announces he can no longer service his debt.

Typically, when such an announcement occurs the lenders usually form a steering committee and rapidly come to the conclusion that they know little about what is really going on with their borrower. In this environment an I/A is appointed and this then generally triggers what can only be described as a game of "cat and mouse". The basic strategies include:

- The borrower immediately seeks to limit the scope of the I/A based on the high cost and an inherent desire to keep lenders in the dark for face and negotiating tactical reasons.

- The I/A then encounters difficulty in getting information on a timely basis.

  In the APP assignment the accounting firm who was retained to do the I/A task, had to submit every information request in writing for the personal approval by the CEO before anything could be released.

  At its most simplistic, these early skirmishes limit the effectiveness and the timeliness within which information can be assembled, analysed and reported upon.

- I/A typically reports to lenders with a copy to the borrower.

  In both TPI and APP the borrowers insisted on editorial control over the report. Initially they wanted to see the report before the lenders saw it, but a compromise was reached whereby the report was issued concurrently to both parties with the borrower having the usual right of objection or disagreement.

- In both cases the borrower sought to try to "handcuff" the I/A by not paying his fee during the period immediately prior to the issue of the report.

  In the APP case this delayed the accounting firm who was producing the report by 3 months, such that the information reported upon was 12 months old when it was eventually issued, thus keeping the lenders in the dark about anything useful and the information at that stage was virtually useless.

5.2 I/A Tasks

Turning now to other tasks assumed by the I/A.

These include:

- A key feature of the major Asian restructurings has been debt / equity swaps and buy back arrangements.

  Thus the I/A generally provides advice on valuation of equity of the borrower.

- The sale of operating assets is generally subcontracted to corporate advisory groups, as is specialist valuation assignments.

  Typically there is also strong resistance to selling non core assets mainly for face reasons.

  In TPI the sale of power station assets was frustrated and was abandoned because of active labour union intervention that ultimately dissuaded investors from proceeding.

- In relation to reporting obligations it is clear that the I/A has to avoid any accusations of bias. Thus it is important everyone gets the same report. In Thailand it is a statutory requirement that all creditors get the same report.

- Other features of major workouts include what is a natural tension between the directors and the I/A. Typically the directors are nominees of the majority family shareholder.

  The tension arises from:

  - face Issues
  - sensitivity to likely criticism of directors by I/A for poor corporate governance.
  - director's belief that a better deal can be negotiated in an "information vacuum" with an uninformed lender group.

- One key issue is ensuring the integrity of the information being reviewed.

  Part of the problem in Thailand and Indonesia is that there is no actual enforcement of directors' fiduciary obligations to report honestly to stakeholders.

  Additionally in Thailand the Court process is slow and cumbersome.

  There is nothing to encourage directors not to trade whilst insolvent such as piercing the corporate veil or exposure to personal sanction.

  I mentioned at the commencement of the paper the role of the I/A acting as an effective bridge between borrower and lender to enable:

- possible preservation of future banking relationship
- the I/A to act as a buffer between various lender creditor groups who may seek to get an advantage over other lender groups.

These represent crucial roles and objectives in any I/A assignment.

Cross border issues are common in major restructurings

5.3 Security

This occurred in TPI where domestic lenders had security over majority foreign creditors.

In APP, where the Chinese banks had their security serviced in full over the last 2 years while foreign creditors had a moratorium imposed on them.

In TPI, whilst being a domestic credit risk there were problems with the valuation of shares for different lenders from different countries who had different prudential / regulatory valuation bases, such as for a European v's American lender.

5.6 Other Issues

In APP major cross border issues encountered related to:

- management control
- transfer pricing
- potential improper value transfer between Indonesia and Thailand
- different I/A's in different locations

Whilst many of the fundamentals are the same in the role of the investigating accountant, there are many contrasts resulting for a myriad of reasons. These differences ensure that the accountants lot is never dull!