

Richard Turton Award 2019

Attitudes towards investing capital in restructuring and turnaround situations, and the multiplier effects deriving therefrom.

Odwa Ngxingo

Sponsored by



Attitudes towards investing capital in restructuring and turnaround situations, and the multiplier effects deriving therefrom.

Introduction:

This paper should be read as a contribution to the insolvency, business recovery and restructuring discourse and not as an academic paper. Its focus is on how the attitudes and biases present among providers of capital towards insolvency, business recovery and restructuring situations, impact the broader business cycle and the investment universe, with lasting implications on economic performance especially in the context of emerging markets similar to some African countries.

The flow of capital into special situations is vital, however the success of its deployment can only yield greater returns in environments where collaboration among key stakeholders and the resourcing of appropriate skills alongside the funding are present, backed by effective implementation. The negative ripple effects that poor performance and distress have on economies are undeniable, though in some instance distress and failure become catalysts for dramatic change, making way for innovation and growth; in the words of Joseph Schumpeter the “gale of creative destruction” which describes the “process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one”.

The 2019 INSOL Europe Congress, convened in Copenhagen, explored practical considerations and intricacies encountered in special situations under the theme (un)necessary restructuring, which spoke to the “(un)fortunate” reality that some businesses may not be worth saving in cases where survival will have a net negative effect on industries and economies in the long run. In addition to the thriving businesses, saved businesses contribute to a stronger base, from which net positive economic growth can take root. Notwithstanding whether growth is a result of organic growth from existing participants or by way of new entrants and innovation, either way the success of any economy hinges on the preservation of value and a sustainably viable commercial infrastructure.

A brief overview of restructuring and turnaround situations:

Restructuring¹ can be defined as an action taken by a company to significantly modify its financial and operational aspects, usually when the business is facing financial pressures or distress. It is a corporate action taken that involves significantly modifying the debt, operations or structure of a company as a way of limiting financial harm and improving the business. A turnaround² is the financial recovery of a poorly performing company, economy, or individual. Turnarounds are important as they mark a period of improvement while bringing stability to an entity's future. To see a turnaround, an entity must acknowledge problems, consider changes, and develop and implement a problem-solving strategy.

South Africa introduced Chapter 6 of the Companies Act 2008 (Act 71 of 2008) (the "Act") on 1 May 2011, which provides for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders³, replacing Companies Act 61 of 1973. Financial distress per Section 128(1)(a) of the Act is described as a situation where -

- it appears to be reasonably unlikely that the company will be able to pay all of its debts as they become due and payable within the immediately ensuing six months (commercial insolvency); or
- it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months (factual insolvency).

Attitudes towards investing capital in restructuring and turnaround situations:

Once a business goes into business rescue or appears to have signs of insolvency, securing capital or finding short-to-medium term financing for the business in question becomes all the more challenging, as funders tend to be sceptical towards the business' ability to repay the funding, and in the event of default, the funder's likelihood of recovery. Some aspects of the scepticism are well warranted, as some funders have previously been burnt and will be wary of what may appear to be "messy" situations. In the words of

¹ <https://www.investopedia.com/terms/r/restructuring.asp>

² <https://www.investopedia.com/terms/t/turnaround.asp>

³ <http://www.cipc.co.za/index.php/manage-your-business/manage-your-company/private-company/changing-status-your-company/business-rescue/>

Mark Twain “history doesn’t repeat itself, but it often rhymes”; in the case of funding distressed businesses, past experiences, especially painful ones, leave a lasting impression, resulting in sticky emotional biases.

Emotional biases inform the nature of attitudes that providers of capital may have towards difficult situations. When defining emotional biases, the Chartered Financial Analyst Institute (“CFA”) curriculum⁴ states that “emotions are related to feelings, perceptions, or beliefs about elements, objects, or relations between them and can be a function of reality or the imagination”, and further highlights that in the world of investing, emotions can cause investors to make suboptimal decisions.” Among emotional biases prevalent among capital providers (funders) in distressed situations are the following⁵ -

- *Regret-aversion bias* - an emotional bias in which people tend to avoid making decisions that will result in action out of fear that the decision will turn out poorly. Simply put, people try to avoid the pain of regret associated with bad decisions.
- *Status quo bias* - an emotional bias in which people do nothing (i.e. maintain the “status quo”) instead of making a change. People are generally more comfortable keeping things the same than with change and thus do not necessarily look for opportunities where change is beneficial, leading to failure to explore other opportunities.
- *Loss-aversion bias* - a bias in which people tend to strongly prefer avoiding losses as opposed to achieving gains. A number of studies on loss aversion suggest that, psychologically, losses are significantly more powerful than gains.

The presence of these biases and limited exposure to different asset classes and / or investment strategies cause providers of capital to operate within parameters that (i) they may be familiar with, and (ii) mirror those parameters which are followed by those around them. As a result, herding and group thinking trumps exploring new opportunities which could potentially yield higher social and economic returns. Perceptions and thinking around special and distressed situations investing must evolve as an enabler to efficient distressed markets.

While there may be investors who are averse towards investing in difficult situations and the related risks, it is not uncommon in difficult situations to witness a relatively risk-averse investor displaying risk-seeking behaviour at the same time, usually because the investor already has exposure in a particular distressed business and would be willing to invest a little more with the hope of recovery of the existing investment.

⁴ 2020 CFA Program curriculum, Level III Volume 2: Reading 8 - The Behavioral Biases of Individuals, by Michael M. Pompian, CFA
⁵ As defined in the 2020 CFA Program curriculum, Level III Volume 2: Reading 8 - The Behavioral Biases of Individuals, by Michael M. Pompian, CFA

This behaviour points, again, to investors loss-aversion bias (i.e. holding on / reinvesting in the losers in the hope of a recovery). Whether from new or existing investors and creditors, the availability and ease of deploying capital to fuel successful turnarounds and restructuring rest also on the legal frameworks and economic infrastructure present in the countries or regions in which distressed businesses operate.

The multiplier effects in the context of preservation and economic growth:

Unfortunately unmonitored biases, compounded with a lack of accurate and timely information, particularly in regions with less robust legal frameworks, leads to the “fog of war” wherein decision making can be particularly challenging, leading to foregoing opportunities for impactful and developmental investing, especially in emerging markets where it may take several generations to rebuild businesses to their pre-insolvency scale. On the flip side, funders lose out on the potential investment diversification benefits present by virtue of the countercyclical nature of distressed investing. It is worth acknowledging that in some instances the resistance and avoidance of distressed investment opportunities could simply be a factor of limited pools of capital in certain jurisdictions with tight restrictions and little-to-no wiggle room as dictated by investment mandates, where the opportunity cost of any spend and investment needs to be carefully considered within tighter limits as a result what may take a longer time to understand and attain sign off may be avoided by default.

Over and above the joint mission of insolvency, business recovery and restructuring practitioners, together with all affected stakeholders, the backing of capital dedicated for distress and special situations affords a better chance for successful rehabilitation of businesses, preservation of value, recovery of profitability, revitalisation of credit markets among others, which ultimately fuels economic growth and allows new businesses to build on a healthy commercial ecosystem comprised of effectively saved and thriving businesses. The benefits of preserved value and business are not only limited to saving jobs, but also include other far-reaching benefits such as the social impact of a viable commercial platform that provides opportunities for wealth creation, earning a living and contributions to the government tax base. Together, this leads to the creation of an environment that allows for higher levels of joy, contentment and a sense of pride, which potentially contribute to a more cohesive and healthier society. Such an environment is still only a distant dream for most emerging markets, including most African countries, where –

- the necessary legal frameworks, regulation and laws, as well as financial and broader economic systems are underdeveloped or lacking; with
- a greater number of vulnerable communities, living in poor conditions; as well as
- higher unemployment rates, resulting in low-to-very little disposable income and consumer spending, which translates into a much less addressable market needed to fuel demand and scalability of businesses and the economies similar to that of more developed markets such as in the United States, Europe and the United Kingdom.

The need to address these challenges necessitates a shift in perceptions towards distress and turnaround situations, to enable more capital flow and investment into distressed economies and businesses as a matter of urgency. It will take a lot more work, time and deep investment into emerging markets such as those in the African continent, to catch up with the rest of the world and address the myriad challenges faced by emerging markets. The type of investment necessary is not only limited to financial capital, but also critical is the investment in people, business processes, and systems, and this needs to be prioritised with a great sense of urgency by national and global governing bodies and investors, policy makers, the business community and the local work forces.

Though there is still a long way to go, it is encouraging to see more and more organisations taking a global view, including empowering emerging markets, in the way they design and invest in solutions that seek to have a world-wide impact and support the development of viable and sustainable distressed markets even across emerging and underserved markets. Programs such the International Finance Corporation’s (“IFC”) Distressed Asset Recovery Program (“DARP”) are testament to this fact. Through DARP, the IFC and its partners seek to promote close collaboration in advancing the development of more efficient financial and distressed asset markets with the following envisaged benefits⁶ of well-functioning and vibrant distressed assets market in mind:

- For **investors**, a distressed assets market provides access to potentially attractive returns. It can also help diversify their investment portfolios because of the countercyclical nature of this asset class.
- For **banks**, maintaining a high level of non-performing loans (“NPLs”) ties up an institution’s capital in non-performing assets, putting pressure on long-term profitability and making it harder to absorb

⁶ BOX 1.1: Benefits of a Distressed Assets Market, International Finance Corporation - DARP - Creating Distressed Assets Markets, Lessons learned since the Global Financial Crisis and Opportunities for Investors in Emerging Markets Today - Second printing of updated edition, October 2019.

future losses and strengthen capital buffers. In addition, large NPL portfolios force banks to retain higher levels of capital, reducing their ability to provide new credit, and particularly rescue credit, see above for reasons not to support a reorganisation, which in turn can hinder economic growth as potentially good investments are postponed or abandoned.

- From a **policy** standpoint, a developed distressed assets market provides for an efficient and effective process for cleaning up banks' balance sheets, as it allows for the disposal of NPLs to private investors who bring greater efficiency, expertise, and financing to the workout process. A large volume of NPLs can undermine the reliance on the banking system and erode economic growth.

Insolvency, business recovery and restructuring practitioners also share in the responsibility of preservation of businesses and promotion of economic growth together with other key economic participants and relevant stakeholders, and it is therefore necessary to exercise caution and carefully consider each restructuring, distressed and turnaround situation appointment on its own merit. In the words of Leo Tolstoy in his classic tale Anna Karenina "All happy [companies] are alike, but every unhappy [company] is unhappy in its own way". The practitioner may be tempted to make use of matrices developed from past experience which may have been applied with great success previously in various restructuring and insolvency cases, on the positive side allowing the practitioner to almost standardize the approach followed in the identification of red flags prevalent in seemingly unsalvageable situations. However as effective as these tools may have been in the past, they may not necessarily be applicable in other cases and fail to pick up on opportunities and value that may not have been present in previous engagements. Error in the applied approach may lead to biased conclusions, while placing more weight on historical events than warranted, and therefore threaten the chances of recovery or rehabilitation of the said business, without giving enough consideration to new information and comprehensive analysis and reasoning.

Objectivity and independence are also of great necessity if practitioners are to act for the benefit of all stakeholders involved, avoiding situations where the process benefits the party who initially recommended the practitioner for appointments the most, at the expense of other stakeholders, and risking recovery and sustainability, e.g. -

- instances where the interests of a particular bank or a sub-group of creditors are almost guaranteed preference in the recovery process when certain practitioners recommended and or appointed by

them drive the process, which may incentivise the bank or creditors to keep recommending and or appointing the same practitioner on a series of cases, in turn possibly compromising the said practitioner's independence and objectivity.

With the above being said, any economy, within the premises of necessary restructurings, should benefit from the appropriate rehabilitation of at least one or two businesses as a result of collaborated efforts, which is more likely to yield greater economic benefit possibly than the failure or distraction of one business. For illustrative purposes consider for a moment, a hypothetical economic setting, call it an economy of 5 ("five") businesses. Like any economy with great ambition, this economy aspires to achieve sustainable positive growth which it can achieve through organic growth on the back of an increase in demand, spurred by a growing population and economic stimuli, or through the emergence of new business in the form of new entrants in the same group of existing industries or a creation of new industries and other innovation.

What is of utmost importance is that each business, whether old or new entrants, should as a rule make a net positive contribution to the broader economy. It may be worth noting that it is possible for one new entrant to replace some if not a combination of the existing businesses through innovation by introducing various advanced and more efficient services and or products. While in favour of new ventures with great prospects, keep in mind that a business can also be a previously distressed business (post a successful turnaround) and still remain relevant and possess great underlying value for its shareholders as a standalone asset as well as to the broader community as a contributor to further economic growth and prosperity.

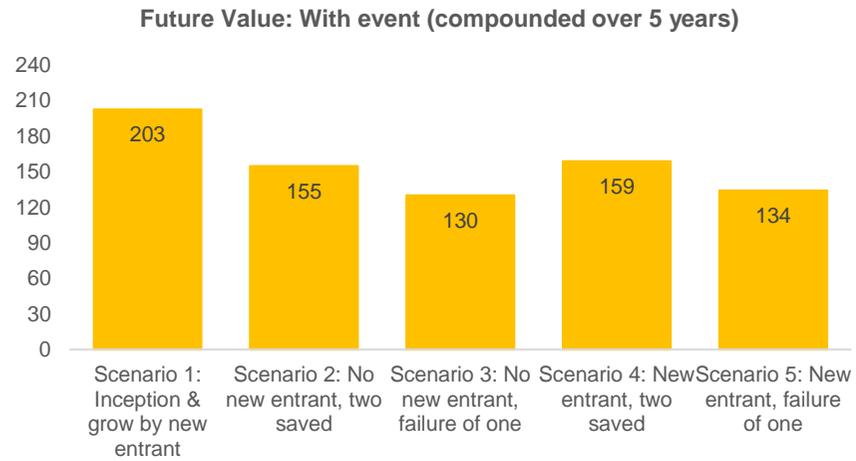
Continuing with our illustrative example of the economy of five businesses. Various situations or scenarios could arise, which could possibly alter the economic dynamics and value generated within the economy. **Table 1** below provides for a conceptual framework that seeks to put forth an argument in favour of effective collaboration among practitioners, creditors and alternative providers of capital such as turnaround funds, with a view to show that better processes and efficient distress markets should yield greater economic benefits on a sustainable basis. The values and scenarios are only for illustrative purposes and are by no means exhaustive.

Table 1:

No.	Entity	Scenario 1:		Scenario 2:		Scenario 3:		Scenario 4:		Scenario 5:			
		Initial ⁷	Contribution %	Post event	Contribution %								
1	Co. A	50	34%	50	34%	50	34%	50	53%	50	43%	50	51%
2	Co. B	50	34%	50	34%	30	34%	0	0%	30	26%	0	0%
3	Co. C	30	21%	30	20%	18	21%	30	32%	18	16%	30	31%
4	Co. D	10	7%	10	7%	10	7%	10	11%	10	9%	10	10%
5	Co. E	5	3%	5	3%	5	3%	5	5%	5	4%	5	5%
6	New Co.			3	2%					3	3%	3	3%
		145	100%	148	100%	113	100%	95	100%	116	100%	98	100%

⁷ Initial – refers to the hypothetical original state of the economy and economic value units contributed by each business, without an event i.e. new entrant, business failure, and or a successful restructure and turnaround

Graph 1:



Graph 2:

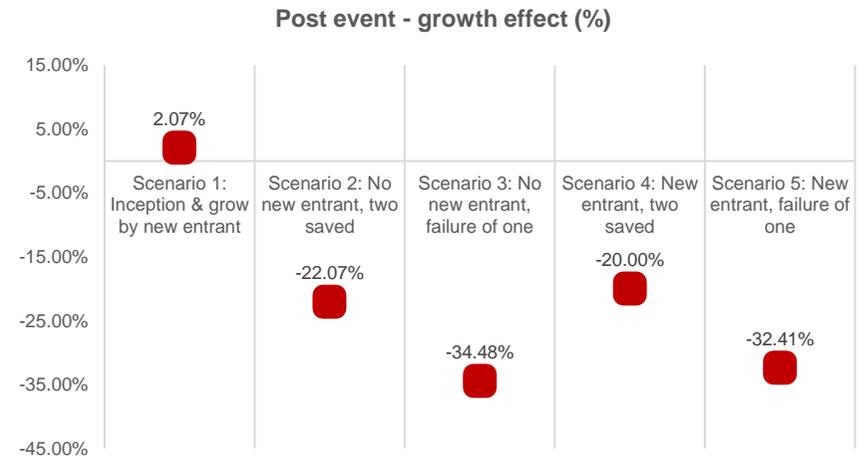


Table (**Table 1**) and graphs (**Graphs 1 and 2**) above seek to paint a picture of the effects various scenarios could have on an economy, supporting the view that economies are better off with interventions that are driven through effective collaboration among the business community, practitioners and providers of capital, even at a global level, with the best interest of all parties and the broader economy at heart.

- The best-case scenario is *scenario 1*, though unlikely, it is not entirely impossible to achieve. In this instance the economy in the near term has a new entrant, building on a stable base of existing business to foster further economic growth.
 - If the aggregate value of economic units contributed in the near term, with the new entrant growing the aggregate value by **2,07%** (i.e. a value of **148** post event), was to grow at a compounding rate of inflation of **6,50%** over a five-year period, keeping all things consistent, the economy would have effectively grown by **37.00%** (to an aggregate value of **203**).

- The second-best scenarios in relative terms, are *scenarios 4 and 2* respectively with post event effects of **-20.00%** and **-22,07%**.
 - Both cases show a less severe impact on the economy when the two companies (Co. B and C) that were successfully restructured and turned around continue to trade though contributing less economic units than pre-event contributions.

- *Scenarios 1, 2, and 4* are indicative of potential value that can be realised and or preserved through effective restructuring and turnaround programmes.
 - Promotion and inclusion of various alternative funding and capital injection models can help bolster the results of these initiatives, hence the importance of the development of efficient distressed markets, while presenting the financial markets with alternatives for diversification and potentially improve portfolio returns.

- Negative growth is evident in the indicative aggregate values under *scenarios 3 and 5*, where at last one business could not be saved, which could be as a result of various issues, which may include, but not limited to –
 - the absence of or insufficient funding and capital investment to enable a turnaround; or

- complexities of a big company, in some instances led by an egoistic or incompetent executive team who are possibly delusional and refused to acknowledge the signs of distress and seek help well in time, claiming to have it all under control till it's too late; or
- a management team that may only be comfortable with running a well-funded going concern; and
- on the balance, not all companies that find themselves in distress are as a result of incompetent management, it may simply be the wrong type of management; square pegs in round holes.

In reality, the effects of distressed business, and even worse in a case where a vital business eventually fails, can have harsh ripple effects, compromising the state of economies, depleting efficiencies in financial and commercial markets, and making it hard for big and small enterprises whose ecosystem relies heavily on the distressed company. Recent South African examples of vital yet troubled businesses that have had noticeable effects, among plenty other originations, include South African Airways, Eskom (a South African electricity public utility), and Steinhoff International (a South African international retail holding company) which have negatively impacted productivity and ease of doing business, extending to almost completely wiping out pension assets of common South Africans.

Evidently, not just the ailing organisation, its immediate shareholders and stakeholders suffer as a result of distress, but suppliers, customers, and the nation (and international markets in some instances) are affected. As the global marketplace continues to become more interconnected, businesses will increasingly develop cross-border networks with exposure across multiple countries simultaneously increasing the risk exposure of banks and other creditors or funders and capital providers. Collaboration at an international level has become of critical importance. Best practice and learnings shared globally to inform policy and market advancement among local bodies such as the South African Restructuring and Insolvency Practitioners Association ("SARIPA") and international organisations such as INSOL International will help accelerate the design and implementation of best practices across the African markets.

Conclusion:

In the words of Dr Eric Levenstein, “effective corporate rescue procedures promote economic and social stability by preserving the value of assets represented by an insolvent or borderline solvent company (where survival of the company, or its business, as a going concern is likely more profitable than a break-up sale of the company upon liquidation), and by preserving the jobs of employees”⁸. Readily available capital and a well-equipped and competent body of insolvency, business recovery and restructuring practitioners precede effective and sustainable change in the restoration of efficiencies and businesses to a place where governance, liquidity and financial controls, operations and human capital, among others are optimised and therefore grow economies and maximise investor returns.

⁸ An extract from Page 258 of An Appraisal of the new South African business rescue procedure, by Eric Levenstein