Placing communication at the heart of restructuring

TRUST IN Resilience

BY LEE CHUI SUM AND JOSHUA JEYARAJ

In the past few weeks, there has been a gradual easing of movement restrictions in most states. As things settle into the "new normal", the financial impact of this pandemic may begin to be fully understood.

PwC's recent Act Now to Recover survey, which looks at disruptions faced by business owners amid the current economic climate, found that 29% of respondents have experienced and also expect to experience a liquidity shortfall in the next 12 months. Therefore, while companies may be able to manage in the short term, they must ask themselves the question: what would happen if cash reserves continue to dwindle and the goodwill and support they have received from creditors run out?

When a company can no longer meet its debt obligations as and when they fall due, there are usually two options available: embark on a restructuring exercise or accept that the business is no longer viable and place the company in liquidation.

A restructuring could entail a gamut of actions such as injection of capital or new business by present shareholders or new shareholders, reduction of lost capital, sale of non-core assets, right-sizing of operations and forgiveness of debt by creditors to trim the debt to a level that can be sustained by net cash flow post-restructuring. The board of directors has to weigh all the options available, balance the rights and requirements of the stakeholders and arrive at a decision on the next steps. Should the board choose to restructure, all relevant stakeholders must "buy-in" for the restructuring exercise to succeed.

It would follow, however, that stakeholders with the strongest claim over the cash flow or assets of a company should have the most say in the restructuring. In cases of distress, this group of stakeholders is likely to be the creditors. Where there is insufficient cash flow to pay liabilities under existing terms, creditors would in all likelihood be asked to consent to some form of compromise as part of the restructuring exercise. A process of negotiation typically precedes creditors' consent to the proposed terms for compromise.

A creditor compromise or debt restructuring will involve trade-offs on both sides and will often involve creditors accepting less favourable terms on their debt to help secure the business's long-term survival. Before creditors agree to such a compromise, they will naturally want to examine the business' plans and forecasts. This will require meaningful communication and efforts to build trust between both parties at every point of the process.

Early engagement makes a difference

Being sensitive to early signs of distress and proactive early engagement with creditors will provide companies with more options to restructure their business. Creditors should have more confidence that their efforts to help the business would bear fruit if the business has not yet deteriorated substantially. For this to work, companies must view their creditors as business partners in their journey to recovery and communicate their pain points in an open manner. Similarly, creditors also need to have a willing mindset to work alongside the troubled business owner to overcome any impediments to long-term survival.

Consider this example: A company operating in an industry hard hit by Covid-19 can be expected to face working capital issues due to reduced sales. Its first instinct may be to negotiate with its trade creditors to lengthen credit terms. However, it could also consider approaching the bank to term out existing working capital debt into a fixed term loan that can be sustained by forecast net cash flow.

In addition, an application for new or incremental working capital facilities may also be considered should there be any unencumbered assets that could be accepted by the bank as security. This is a compromise that could be completed early if both parties come to the table and engage in open two-way communication.

Laying out your game plan

A restructuring is underpinned by a viable and comprehensive business plan that needs to be communicated effectively to creditors. A common tool used by creditors to assess the viability of a business plan is the cash flow forecast that covers the period in which the business plan is to be implemented and the repayment tenure within which creditors can expect to recover their principal and interest/profit in full.

It is therefore important that any cash flow forecast presented to creditors is based on a set of realistic and verifiable assumptions, including operational performance, capital requirements and a timeline for recovery. Companies should prepare themselves for tough questions around these assumptions and they must be open to providing information, explanations and, where permissible under the law, documentary evidence to creditors upon request. Simply put, the cash flow forecast should reflect the company's story of recovery and if accompanied with a strong and well-reasoned narrative, can serve as a powerful means to secure creditors' support.

Negotiation is necessary for building consensus

When a company is in distress, there is a limited amount of cash that can be distributed among stakeholders, including shareholders who are typically the last in line when it comes to company payouts. The allocation of this limited resource forms the core of any restructuring exercise. Each stakeholder has different motivations and a successful restructuring will have to balance such motivations, taking priority of claim into account, in order to arrive at a plan that works for the majority of parties involved.

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If required, companies may choose to utilise various formal corporate rescue mechanisms, such as schemes of arrangement and judicial management, to help achieve a compromise. These mechanisms have rules in place, such as threshold of support required to pass a compromise. For example, if a company wishes to undertake a scheme of arrangement under Section 366 of the Companies Act 2016, it will not require unanimous support from the creditors involved; a 75% majority of the total value of the creditors (or class of creditors) voting in favour will carry the scheme through.

For this negotiation to work, parties must accept that they will not get everything they want out of a restructuring (it is after all a compromise), but they must agree that the sets of action proposed will lead to better recovery compared with the ultimate alternative — liquidation.

Rebuilding trust through restructuring

When a company undergoes restructuring, chances are a certain degree of mistrust has built up between the company and its creditors. This could have arisen from repeated promises to pay that went unfulfilled or non-disclosure of developments that impacted the business negatively.

A trust deficit could directly impact negotiations and even derail a restructuring. To rebuild trust, companies may choose to engage an external adviser or set up an internal independent committee for the purpose of shepherding the company through the restructuring. This adviser or committee would be seen as an honest broker — someone who is untainted by previous actions and can negotiate on behalf of the company with a clean slate.

Once the restructuring has been agreed to and moves into the implementation phase, borrowers should be prepared to be subject to a more rigorous monitoring process by creditors post-restructuring. Instead of viewing this monitoring as a negative invasive action, they should view it as an additional pair of professional eyes to watch whether the implementation of the restructuring goes according to plan.

As the impact of Covid-19 is fully realised, it is likely that more and more companies will look to restructure as a means of ensuring survival. In fact, up to 28% of the respondents in our Act Now to Recover survey have embarked on compromise agreements with creditors to reduce liabilities in the past 12 months, indicating that companies are actively pursuing restructuring and that it is not a foreign concept to them.

Companies that are looking to receive a new lease of life through restructuring should set themselves up for success by acting fast to establish lines of communication and invest time and effort in building trust with creditors. Transparency goes a long way in times of distress, which may pay off through more attractive options in recovery for all parties. E

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