

Looking beyond the balance sheet

Why two plus two doesn't equal five

Much of the funding to the business banking market in recent years has been delivered against optimistic assumptions as to sustainable cashflows. As the economic downturn has gathered pace these have faltered and lending structures have come under strain or become non-viable. We at MCR Business Consulting are seeing enterprise values under attack with reduced cashflows which undermine prospects for recovery of debt through cashflow or going concern business sales.

Restructurings can and do work but need careful planning, robust diligence and effective ongoing monitoring and controls.

Often in these circumstances the client's position is exacerbated by a requirement, at relatively short notice, for new money, which its investors may or may not be willing to subscribe. For banks, often as key stakeholders, this is a massive shift from the theory behind the two plus two formula previously used to support a number of leverage transactions and in turn is driving difficult choices between restructuring of debt through payment holidays, extended repayment periods, debt conversion in return for equity, or alternatively recovery through insolvency.

With many leveraged transactions looking uncertain – surely ABL's are well positioned?

In recent years banks have actively restructured working capital away from overdraft and onto invoice discounting and stock finance, with a view to enhancing controllability and indeed collectability of their commitments. Recent statistics from the ABFA confirm that asset-based lenders are now advancing in excess of £17bn to UK businesses.

But are ABL's well positioned to weather economic challenges through straight forward collect-out strategies? The lender would certainly hope this would be the case in most instances but regrettably all classes of assets tend to be a casualty of economic distress. Debts become harder to collect-out as a higher proportion of debtors enter serious financial difficulties themselves, perhaps elect to contest liabilities, credit insurers reduce or withdraw cover for increasing numbers of clients and, sadly, fraudulent activity increases.

Debtor failure is emerging as a significant risk for ABL's.

Before you know it the sales ledger is beginning to look somewhat ragged at the edges. If the ABL has also extended support into stock it can find that recovery values in insolvency can be a small fraction of book cost unless reflecting an underlying commodity value or translatable into finished and saleable production – we have recently seen a revised stock valuation at £100,000 against a balance sheet value of £1.2m!

In this more complex environment ABL's may find themselves having to contemplate a restructuring scenario either in conjunction with a bank(s) or as lead funder in their own right. Alternatively ABL's may find banks looking to restructure around them. In some cases the in-house ABL may have assumed the working capital role for the parent bank and is, therefore, effectively tied in to the parent's recovery strategy.

Fail to plan – plan to fail!

How then should ABL's prepare for either the restructuring approach or go about planning to lead? In our experience it is vital to realistically appreciate your own backstop position. If this looks

favourable, all well and good, but within these challenging times how do you really know? Our view is to always conduct an up-to-date assessment, as we have found that reliance on out-of-date values can cause embarrassment!

All asset values become very volatile in an economic downturn.

Typically an independent business review will provide a solid base line on which key decisions can be made and also help to create buy-in from management who could have their own views on restructuring and work-out proposal, which may be predicated upon a well thought through business improvement or cost reduction plan.

The form of any financial restructuring has to reflect the realistic prospects for the business for whilst the first time round it may be able to carry the support of suppliers, customers, employees, management and tax authorities it may well be practically impossible to have a second bite at the cherry.

Are you risking a greater loss in the future by deferring a crystallisation now?

Whilst the number of situations where restructuring is contemplated rises exponentially in a down-turn the experienced work-out banker or professional advisor knows that not every case makes sense and ultimately comes through. The difference between the successes and the failures is often influenced by timing and capability, where both are in short supply perhaps you should remember the old maxim in banking: "Your first loss is often your best loss"!



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