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## Facing the GFC's Catch-22: Getting the balance sheet back on track

One of the most devastating impacts of the global financial crisis (GFC) was the way it effectively stopped the flow of funds to companies as lenders focused on managing their own deteriorating asset positions. Those businesses relying on lenders to meet their working capital needs and growth aspirations found themselves face to face with a fiscal drought of unprecedented proportions.

Many companies with maturing debt facilities or at risk of breaching loan covenants – already struggling with weakening underlying results and significant losses from asset write downs – ended up unable to obtain alternate funding. Declining equity markets and eroding asset values meant the opportunities to re-engineer the balance sheet were limited.

Over the last 18 months, many Australian companies have found themselves dealing with a classic Catch-22 argument: they needed to hold an equity raising to satisfy their lender's requirements, but potential equity investors would not hand over a dime unless they had absolute certainty regarding debt. How do you get one without the other?

Our experience over the last few months confirms that the answer lies in the creation of a comprehensive, well-structured capital management plan. In this issue of *Ferriers Focus* we will look at how we have helped companies overcome the Catch-22 issue and provide some suggestions on how to develop your own restructure plan.



### That sounds like a plan

The starting point for all firms is to pull together a comprehensive and well-structured capital management plan addressing the following areas:

- **Get the basics right.** Consolidate, stabilise and improve the underlying performance of the core business operations.
- **Sell, sell, sell (and plan).** Identify assets suitable for sale and establish clear plans on how the sale proceeds will be applied to debt reduction, working capital, capital expenditure or growth activities.
- **You do the math.** Calculate the amount of equity required, the method of equity raising and the pricing level required to restructure the balance sheet.

- **Chart a course.** Map out a comprehensive resourcing and financial management plan showing the firm's capacity to achieve improvements in business operations, asset divestment, organisational change and control over finances.

### Get the basics right

One of the keys to conducting a balance sheet restructure through an equity raising is to demonstrate that the core business is sound with underlying performance and growth prospects that will both reward investors and satisfy the requirements of lenders.

At the onset of the GFC, many businesses suffered as customers stopped placing new orders and opted

instead to rely on existing inventories. Many businesses turned to discounting to maintain sales targets, resulting in diminishing margins and potential breaches of banking covenants.

“Company A” is an unlisted public company in the high-tech sector which was in the midst of its growth phase at the end of 2008, carrying disproportionate amounts of WIP and debtors on its balance sheet. The company was effectively driving its sales growth and funding its major clients by increasing its debt.

Company A’s investors and secured lender demanded the company come up with a plan to show how it could improve its bottom line sufficiently for them to agree on terms for an extension of its loan facilities, including a suite of new covenants more suited to the company’s position.

Appointed to undertake a strategic review for the lender, Ferrier Hodgson was able to assist Company A to develop a capital management plan outlining how the problems were to be addressed. The plan took action on three fronts:

- Improving the working capital position. Company A renegotiated terms with customers, billing WIP on a more frequent basis and focussing on total return from projects rather than top-line sales growth.
- Implementing a suite of cost-saving and efficiency measures.
- Raising equity from existing shareholders and executives. Company A targeted existing shareholders and executives because they were already committed to the company’s success. The equity raised was predominantly used to retire debt. However, with acknowledgement of the secured lender, some funds were also applied to business systems to promote better management and efficiency.

By embracing Ferrier Hodgson’s appointment and working with us, Company A was able to consolidate its strategies and win the confidence of its investors and lenders. It has since returned to profitable performance and controlled growth.

## Sell, sell, sell (and plan)

Another key element in successfully restructuring balance sheets is to identify assets that can be sold to raise capital to fund working capital requirements, new opportunities or debt obligations. During the GFC, in order to prevent the company from going under many businesses were forced to sell assets acquired at inflated prices, thereby realising significant losses.

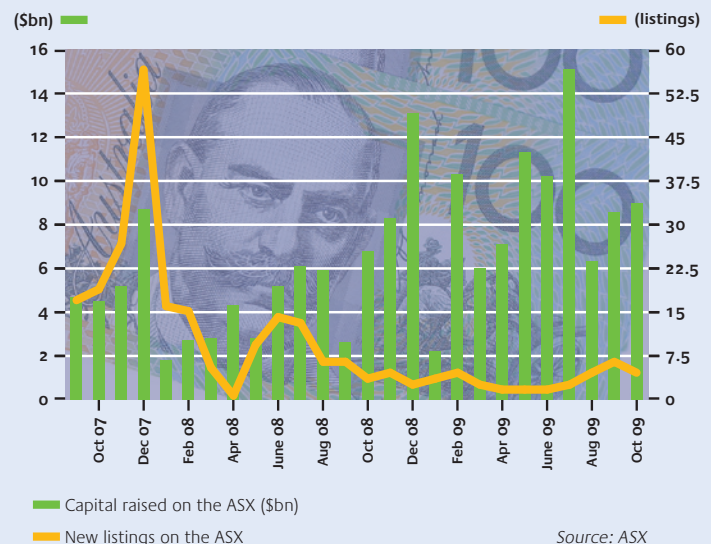
“Company B” had a significant unfunded contractual obligation in relation to a joint venture project. The project was funded through equity and unsecured debt, with the financiers unwilling to advance further debt funding, particularly on an unsecured basis.

## Raising the bar

ASX-listed companies raised a record \$107.5 billion of new equity during the year ending 31 October 2009, compared to \$55 billion for the corresponding period 12 months ago.

Of this, only \$2.6 billion was raised through primary raisings – less than half the \$7.1 billion raised the previous year, but consistent with the falling number of IPOs in Australia in recent years.

Notable equity raisings during the year include National Australian Bank’s \$2 billion placement in July, Santos’ \$3 billion entitlement offer in May and Rio Tinto’s recent US\$3.4 billion rights issue.



To resolve the deadlock, the company and its financiers turned to Ferrier Hodgson for expert industry advice and support. The company sought to fund future obligations through the introduction of new JV partners, a capital raising or a merger. Unfortunately, none of these capital raising activities were successful, forcing the company to sell its rights in the project at a significant loss. But by cutting off this liability, Company B was able to retain the support of its financiers and protect its ongoing viability.

## You do the math

Businesses seeking to raise equity need to decide on the type of equity raising as well as the price that will enable the business to achieve the desired outcome.

Participation by existing retail investors in equity raisings has traditionally been through a share purchase plan, which under ASX listing rules does not require a prospectus to be issued, minimising compliance costs but limiting the number of shares that can be offered to existing investors to between \$5,000 and \$15,000. Accordingly, these shareholders will have their investment diluted in favour of institutional investors participating in share placements – usually at substantial discounts to market. As a result, the choice for existing shareholders often comes down to either voting against the restructuring proposal and risking losing their entire investment or voting to support the restructure and the potential to preserve some value in their holdings with the prospect for future recovery.

Substantial discounts on their own are unlikely to win over investors. Businesses seeking to raise equity will be required to show that the capital raised has the potential to enable the firm to generate future returns.

“Company C’s” lenders raised concerns about the business’s performance and its ability to meet forecasts. In particular, the lenders were concerned about the sale of stock at less than book value. The lenders were also concerned that debt funding was being used to fund research and development and the start-up costs of a new venture.

Ferrier Hodgson provided a strategic review which recommended that additional working capital be

## Raising equity

Five ways retail investors can participate in equity raisings on the Australian market:

- 1 A rights issue**, an offering to existing shareholders to buy new shares.
- 2 An accelerated rights issue** – a two-stage process where institutional investors are invited to participate through an offer of shares and subsequently an offer is made to retail investors.
- 3 A placement to a group of investors.**
- 4 Share purchase plans** to smaller shareholders.
- 5 Dividend reinvestment plans.**

released by exiting a less profitable non-core business which could be used to reduce debt. The company subsequently announced an equity raising through a rights issue with the intention that part of the proceeds would also reduce debt. However, in this case the investors were reluctant to participate to fund debt reduction rather than ongoing investment in R&D.

The company’s inability to adequately demonstrate its intended use of the funds in the planning stage of the equity raising, while successful in raising the funding sought, did not lead to total satisfaction on the part of either investors or lenders and the company continues to carry a funding risk.

## Chart a course

Businesses may successfully address many of these issues, but without support from both lenders and investors and a firm belief the contribution of additional capital will preserve the value of the business, the restructuring process is unlikely to succeed.

Investors must be convinced there will be a superior return on investment for new equity funding and lenders must believe they will see a better return on their debt than by taking immediate recovery action. Critically, lenders and investors must have confidence in the integrity, skill and experience of management

to drive the changes required to deliver the restructure and turn around operational performance.

“Company D” is a listed company that grew through debt-funded acquisition but the impact of the GFC left it struggling to service its debt requirements. Ferrier Hodgson was engaged by the company’s group of financiers to provide independent advice. Working with Company D and its financiers, Ferrier Hodgson helped to develop a package of asset sales, debt reduction and facilities that satisfied the lenders’ requirements for residual debt levels and generated confidence in equity markets to raise sufficient equity to achieve that result.

The company refocused on its core business, sought strategic sale opportunities for non-core assets that returned a superior return than if offered to the market and engaged with its shareholder base, equity markets and financiers. Eventually, the residual debt was structured to meet the company’s needs for term, revolving and ancillary facilities and a revised suite of financial and non-financial covenants were set to match the ongoing business.

## Conclusion

Faced with the twin dangers of breaching banking covenants and maturing debt facilities, the drying up of debt capital was the last straw for many businesses already struggling to cope with the impact of the GFC. Through our experience, Ferrier Hodgson has confirmed the best answer is to map out a comprehensive and well-structured capital management plan. With the assistance of a professional adviser, it is possible to chart a safe course through dangerous waters without resorting to formal insolvency appointments – and as illustrated by the amount of equity raised in Australia over the last 12 months, there is money out there if you know where to look for it.



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