Bridging the Gulf

Restructuring approaches in the Middle East… and what they mean to you

There has been a significant amount of restructuring activity in the Gulf recently, accompanied by a change in the approach of many local banks to lending. Against this backdrop, a number of differences have emerged in the approaches to, and results from, restructuring processes in Europe and the Middle East.

Europe has been through many cycles of boom and bust and the approach to restructuring has been developed and augmented over time, both in terms of the mindset of stakeholders – both companies and banks – and in terms of legal frameworks. Restructuring is viewed as a normal part of a business life cycle, the result of entrepreneurial risk-taking. It is without stigma and is not necessarily seen as the ‘fault’ of management.

In the Middle East, the idea of restructuring is fairly new. The phenomenal growth in the local economies over the past few years has introduced businesses – and sometimes governments – to the major international debt markets and that has brought with it exposure to global macroeconomic trends. The most recent global financial crisis signaled the first instance that many businesses and lenders in the region have had to face up to the idea that their businesses may not keep growing and that their debts may not be repaid in full and on time.

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With respect to the legal frameworks, many Middle Eastern jurisdictions had not previously considered the possibility that businesses would fail, or be unable to repay debts, meaning that the appropriate legislative frameworks had not, until recently, been put in place. This leads to an uncertain environment for banks with regards to their contingency and enforcement options, should consensual discussions with a struggling business not bear fruit.

The environment for restructuring in the region is less mature than it is in Europe and the United States, for example, where the Insolvency Act in the U.K. and Chapter 11 in the U.S. are well-established covenants that offer a degree of comfort that a predictable legal outcome can be expected. Comfort in the lender’s security position gives them and the company a base from which to negotiate.

Lessons to learn from recent restructurings

A key lesson learnt so far from restructuring activity around the region is certainly the need to act early. Companies and/or lenders can be in a state of denial about the situation their businesses face and as a result choose not to act until it’s too late.

A case in point is Dubai World, which, in November 2009, caused shockwaves throughout the financial world with the surprise announcement that it could not pay the Nakheel Sukuk amortization of $3.5bn due in December 2009. Aidan Birkett, ex-head of Deloitte U.K. Corporate Finance, was immediately appointed as Chief Restructuring Officer (CRO) for the group, however, there remained insufficient time to pull together the crisis management plan required. The announcement was a revelation to the lending and led to a collapse of confidence in the region.

The importance of anticipating where and when problems may arise, preparing for restructuring and communicating with the lenders cannot be overstated. The primary focus should be having a robust and sensible business plan, supported by a proper set of processes and systems in the business. It is key to adequately forecast cash flow and covenant compliance to be able to foresee any problems with plenty of time to react appropriately. The mantra in restructuring: cash is king.

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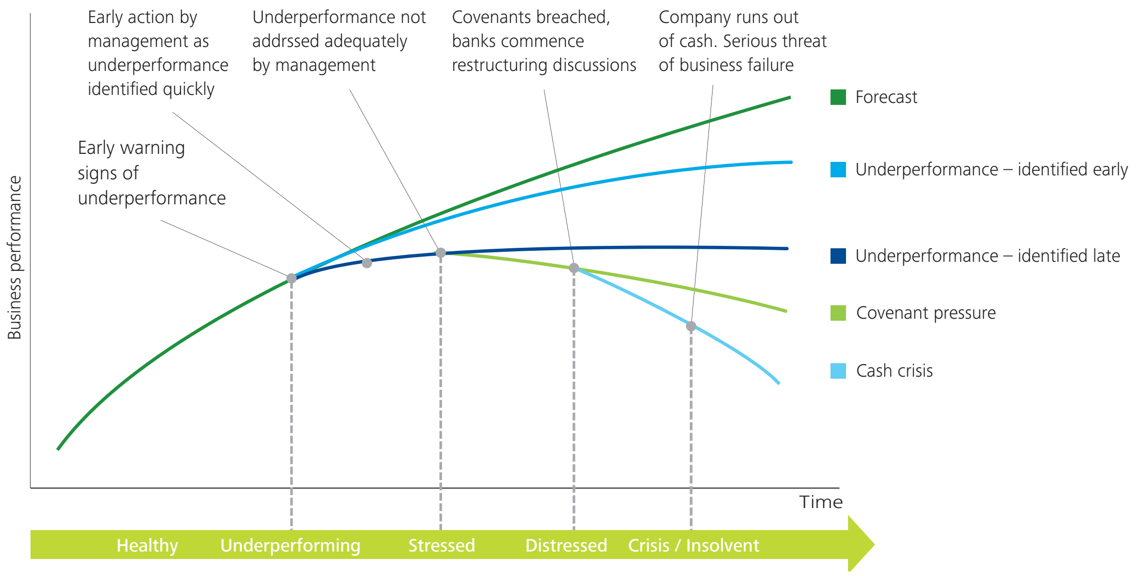

Restructuring is usually required where the continued underperformance of a once healthy business leads to a fall in shareholder value and severe and sustained pressure on debt covenants and liquidity that creates a fundamental uncertainty as to the future of a business.

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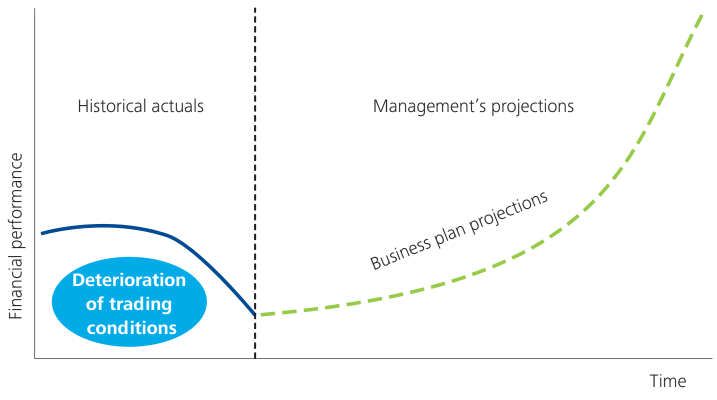

The importance of getting the business plan right

Lenders can tell immediately when a business plan is not well thought through, achievable, or sufficiently detailed, portraying the management as lacking in credibility. Lenders may, as a result, opt out of supporting that given business. An ill-thought out business plan changes the banks' approach to any negotiations and may impair their view of the management team.

One of the main considerations in a business plan is its feasibility. There is little credibility in a business that is seen to struggle in a declining market that is showing no signs of recovery while predicting double-digit growth for the next few years, especially if this is what is required to deliver full repayment of the debt. Lenders will not be keen to refinance a clearly unachievable plan, unless it is to improve their security position when they do finally enforce over the business.

It is of course necessary to strike a balance. If a business plan shows no ambition or growth, it is unlikely to gain favor from a bank. Banks look for a combination of growth and realism, ambition and pragmatism. This may often lead to a business having two business plans – a 'banking' case and an 'equity' case. The first would be fairly prudent and something that a business will happily set covenants against, whereas the second would be used for different reasons, such as incentivizing management.

Something else to remember about the business plan is that it cannot be just a financial model, compiled once during the refinancing process, then locked away in a cupboard. It must be updated and revised on a periodic basis. It is also vital that a suitable management structure is put in place. This management team must then develop a plan that activates the financial model and sets a clear path to achieving the financials through day-to-day actions. Finally, the management team must be able to adequately measure performance against the plan through management and financial reporting of both forward - and backward - looking key performance indicators.

Conclusions

It is vital not to attach a stigma to restructuring. It can be a perfectly normal course of business for healthy companies in struggling markets, or for those saddled by their owners with inappropriate capital structures. Ignoring the problem will inevitably create another and result in a worse outcome.

Prior to this, it is necessary to know if trouble is coming your way, so having a robust and regular business planning and forecasting process in place is key.

When it comes to communications with lenders, corporates will do well to recognize that there is a move away from the previous standard of lending based on name, with numerous bilateral facilities. In distressed situations it may be the case that a business faces a collective group of lenders rather than individual lenders and may not be dealing with their previous relationship manager. A robust, measured approach to negotiations must therefore be adopted involving significant preparation.

To enhance business value and ensure continuity, a sustainable focus on rectifying internal business performance, rather than relying on friendly banks, is crucial

It is clear that the type of restructuring solutions reached in the region will continue to develop. The 'extend and pretend' answers that we've seen in the past, where the terms of facilities are simply lengthened, will no longer address the key problems many businesses face, nor will they necessarily offer the best solution. To enhance business value and ensure continuity, a sustainable focus on rectifying internal business performance, rather than relying on friendly banks, is crucial.

by **David Stark**, managing director, Restructuring Advisory Services, Deloitte Corporate Finance Limited