

e-bizzline

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The credit crunch: a practical guide



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Introduction

The credit crunch has rapidly made its way from the USA to all corners of the world, including South Africa, and a wide range of industries are feeling the pinch. Slower growth, the weakening rand, and rising interest rates compound an already difficult environment in which key commodity prices and the rand are falling rapidly. Some geographies and industries are proving more resilient than others. Although Trevor Manuel provided some reassurance that South Africa falls into that category of resilience, our general advice to clients is to take proactive steps to prepare for potentially challenging days ahead.

The current upheaval in the credit markets is analogous to riding a rollercoaster for the first time on its way down a steep hill. It has everyone holding on tight, hunkering down, with a sick feeling in their stomach and wondering when the worst will be behind them. No doubt, 2008 has been a rough ride for the global economy and the financial and resources sectors. It seems that each week another major bank failure, economic crisis or government bailout is grabbing headlines around the globe. Keeping track of all of the events and understanding what impact they will have on us in South Africa are daunting tasks.

The current upheaval in the credit markets is analogous to riding a rollercoaster for the first time on its way down a steep hill.

In this guide, we take you through 10 points and provide useful and practical information to assist you as you navigate through this difficult time. We've also included a diagnostic questionnaire to help you determine if your business or that of your suppliers or customers might be at risk of financial distress.

With careful planning and foresight, you might even be able to turn conditions to your advantage. Businesses that are well capitalised, well positioned, and well managed should see opportunities.

Most of our suggestions are about good business practices. Management teams often ignore the fundamentals when the focus is on revenue growth, as it has been for several years now. The coming months should be about instilling rigor and discipline throughout your business.



Cash is king



What's the issue?

Cash is the lifeblood of any business and it matters more than earnings. As the saying goes, “Profits are an opinion, but cash is a fact.” More and more, bankers, investors and advisory professionals focus on the often-ignored cash flow statement. If earnings are growing faster than cash flows, red flags are raised.

In a slowing economy, understanding and managing cash flow are of paramount importance. Customers are likely to pay their bills more slowly, sales and profitability will likely diminish, and banks are less inclined to lend against insufficient or aging collateral. Liquidity can become constrained very rapidly. In recent history, many businesses didn't keep a close eye on their cash flows or near-term liquidity because it wasn't necessary. Banks were happy to step in and fill funding gaps.

What can you do?

Undertake a critical analysis of your business operations and understand the resulting impact on liquidity. Focus on the components of working capital and the cash conversion cycle. Build and conserve cash. In a financially distressed business, build a war chest of cash, even at the expense of drawing down on interest-bearing credit facilities. Forecast near-term cash receipts and cash disbursements based on realistic financial projections and a sound starting point and include an analysis of the impact of those assumptions on your borrowing base.

If you have cash on your balance sheet, you have a greater degree of flexibility in your decision-making.

Undertake a critical analysis of your business operations and understand the resulting impact on liquidity.

Analyse variances and learn from them. If you can't produce this from information you have, bring in outside help. You need to look beyond sales and expenses and focus on actual cash, not EBITDA.

Negotiate aggressive credit terms with suppliers and customers. As soon as invoices are late, begin subtle but firm collection efforts. If customers believe they can use you to finance their own cash needs, they will. Reduce inventory levels and replenish on a just-in-time basis, to the extent practical. Sell aged inventory. In the short term, it may be wiser to sacrifice profitability in order to generate cash, but keep an eye on your borrowing base. Advance rates on inventory tend to be low, so focus on selling inventory to generate cash.

What can be avoided?

Remember that bigger is not always better. Growth consumes cash. A significant sales opportunity that appears profitable on its face may have dire consequences on a company's cash conversion cycle and its ability to finance it in this volatile market. An increase in the duration of the cash conversion cycle is a negative signal. Thoroughly consider the implications to cash flow from increased sales requiring capital expenditures and ramp-up periods. Understand the worst-case scenario, and make decisions accordingly.

Be relentless on cost control

02

What's the issue?

In order to maintain your current or historic levels of profitability in an environment characterised by decreasing demand and increasing commodity prices, you will almost certainly need to cut costs and spending where possible. Escalating costs will cause margin compression and in turn put pressure on liquidity. Tough economic conditions require a razor-sharp focus on cost containment at a minimum, and cost cutting where possible.

What can you do?

Employ zero-based budgeting to review all costs very carefully in terms of their value to the business. What costs do you actually need to run the business? Conduct relative risk and benchmarking analyses against competitors in the industry, and look for ways to improve performance. Reduce spending as much as possible, and hold managers accountable for all expenditures and cash outflows. Institute cost justification and baseline investment returns on new projects.

Understand your fixed and variable costs and any outstanding liabilities not reflected on your balance sheet (e.g., operating leases, rents, performance contracts) and find opportunities for reducing costs. Pay close attention to variable costs, and completely reconsider any capital expenditure decisions. Institute policies that encourage and reward cost savings and cash conservation.

Look hard at discretionary expenses and pick off the easy wins in areas such as travel, general expenses and entertainment — but don't compromise your business strategy.

Talk directly to all employees, not just your management team. Validate all significant assumptions you've made about your business, your competitors and the industry in which you compete.

Carefully consider a major area of cost: people. Make tough decisions now. Don't allow emotion to rule your decision-making. Use objective criteria to ensure that decisions are made in the best interest of the business and not based on personal relationships. Communicate well, retain integrity throughout the process, but move quickly. Instill confidence in your decisions and motivate those who are left.

What can be avoided?

Don't automatically cut marketing expenses. While this is traditionally seen as an easy target, doing so can have a significant impact on your competitive position, particularly when market conditions pick up. There's a lot of business out there, and in a slowing economy, it becomes a matter of having to try harder to grab share.

Think about your business and, more importantly, your strategy. Cost-cutting initiatives cannot be undertaken at the risk of diminishing value.



Evaluate customers and suppliers

03

What's the issue?

The recent challenges in credit markets, as well as a general economic downturn, have all put increased pressure on the purchasing power and creditworthiness of customers. This and the introduction of the National Credit Act have resulted in a tightening of credit terms and product availability from suppliers.

What can you do?

Re-evaluate credit terms with customers and negotiate the shortest reasonable terms. Carefully review (and continuously monitor) the creditworthiness of each new and existing customer before extending credit. This will better ensure full repayment in accordance with stated terms. Monitor the customer accounts receivable aging and quickly address any accounts that are past due. Request regular financial information from your largest customers to identify and evaluate risk. The buyers of your services may themselves not understand the financial position of their employer.

Ask yourself a simple question: If your customer were to become insolvent tomorrow, what would happen to your business? It's prudent to understand the credit profile of any customer that could severely impact your business if it runs into trouble. As an unsecured creditor in an insolvency, you will likely collect a fraction of your receivable, and only at the conclusion of a lengthy legal proceeding.

Make sure you understand the financial well-being of your customers and suppliers. Look for signs of financial distress, and express your concerns. Ask for financial information on a regular basis, and analyse it carefully.

Do you need to consolidate your suppliers, put more of your business with fewer providers and negotiate more favourable terms for your business?

Understand how closely your business is linked to mainstream consumers. Your proximity to, or distance from, them will indicate how quickly your business will be affected as consumers exercise greater caution in their spending patterns. The most vulnerable sectors will be those that rely on discretionary consumer spending and credit, such as housing, automotive, retail and other consumer durables and nondurables.

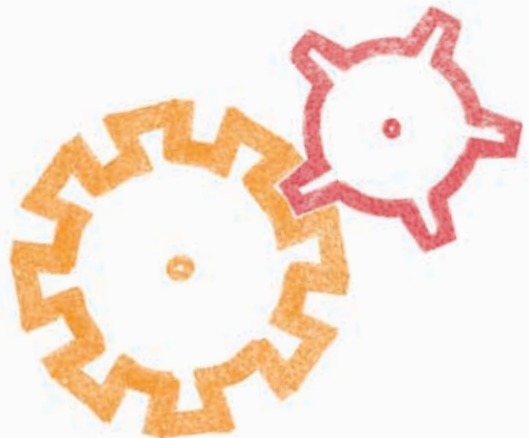
Take the opportunity to bargain with suppliers for the most favourable credit terms that are as long as possible. To the extent excess cash is available, negotiate for early payment discounts, because most suppliers will be hungry for cash. Critically evaluate whether you need more or fewer suppliers. Do you need to expand your supplier base because some of your suppliers are financially weak? Do you need to consolidate your suppliers, put more of your business with fewer providers and negotiate more favourable terms for your business? Either strategy could work, but only a robust analysis will provide the right answer for you.



What can be avoided?

Don't assume your customers or suppliers are financially healthy. Look for red flags of distress. Failing to promptly collect receivables may result in a cash flow shortfall that could affect all areas of your business. Accordingly, extending unreasonable credit terms in the hope of bolstering revenues may be equally detrimental.

Immediately investigate any hiccups with your suppliers. Make sure delivery or quality mistakes are just that and not an indicator of more systemic problems.



04

Get smarter on tax

Tax, in various forms, is usually one of the biggest overhead costs in a business, and it is important to look carefully at how to manage that cost and the related impact on a company's cash flow.

What's the issue?

It is important to take appropriate advantage of the opportunities available to reduce your tax liabilities, such as fully utilising available deductions and allowances and making the least allowable estimated tax payment.

What can you do?

Corporate taxes

- Take appropriate advantage of the available deductions and allowances. These would range from claiming optimised wear and tear rates on assets used in the production of income to establishing whether any research conducted qualifies for any special tax allowances.
- Make use of available Secondary Tax on Companies (STC) credits when declaring dividends.
- Do not pay more provisional tax than what you are required to by law.

Indirect taxes

- Pay attention to unclaimed VAT that may be held up in your system.
- Consider the timing of the liability to pay the VAT on your outputs.

- Register for e-filing – payments through e-filing are only due on the last working day of the month, as opposed to the 25th of the month in which the payment is due.

These steps represent some basic ways to reduce tax costs and improve cash flows. However, there are a number of additional planning ideas that might be suitable, depending on your facts and circumstances, if you are considering major commercial transactions or restructuring.

What can be avoided?

Companies should avoid missing required payments and filings for all taxes. Trying to borrow from the government by putting off tax payments in the short term can result in significant interest and penalties. In cases where payment is not possible, taxpayers should file their tax returns, and work with SARS to develop a payment plan.

Where companies move funds around within a group of companies, they should be aware of the possible tax implications. These could range from creating deemed dividends on which STC could be payable, to transfer pricing or thin capitalisation adjustments in the case of cross-border situations.





Reconsider capital investment plans

Ask yourself if now is really the time to invest in new capital assets. Look for extended terms from vendors if it's absolutely necessary. Consider leasing to minimise the impact on cash flow.

What's the issue?

Investing in new assets in a downturn can bleed you of cash when you need it most. Carefully consider your capital investment plans, and question the proposed value and timing.

What can you do?

Take into account the timing of investments. If it isn't critical, consider delaying or deferring it. For a critical asset, negotiate to acquire it under the most favourable terms, including, but not limited to, the use of debt financing to the extent available. It is essential to weigh the operating and tax benefits of the investment against the financing costs, especially in a lending environment that has become considerably more challenging. Cash flow budgeting should properly account for increased borrowing costs as well as constrained credit availability.

Attempt to fully understand changes to working capital that may result from a particular investment. The project may require increases, or decreases, in cash, accounts receivable, accounts payable or inventory. These changes in working capital should be included in the calculations we discussed earlier, as should economic value at the end of the life of the project.

Also be mindful of how recent changes in economic conditions and challenges in the lending climate are affecting your customers. The National Credit Act has made loans harder to get, and a weakening global economy will likely cause consumers to spend frugally in the coming quarters. Capital budgeting metrics (such as net present value and return on investment) should incorporate realistic assumptions based on current economic conditions. This will aid practical decision-making about whether to move forward with prospective investments.

What can be avoided?

The easiest thing to do is to just stop investing in capital during difficult times. Don't do it. Failure to make necessary investments or maintenance capital expenditures can put you on a slippery slope. If an investment is vital to keep your business operating properly, don't suspend or postpone the investment decision just because financing is more expensive and complicated.



06

Get closer to your bank

Take a hard look at your reporting and accounting systems. If these are weak and not quite what the bank would like to see, seriously consider improving them quickly.

What's the issue?

Given the current state of the worldwide credit markets, banks will continue to be cautious and concerned about credit quality. As a result, they will need greater persuasion to lend you more money if you need it.

What can you do?

Treat your bank as a partner in the business. Keep them informed and help them understand your business, your industry and competitive dynamics. Be sure to give them plenty of notice if you need help. The last thing a bank wants is to receive a week's notice that you need to double your overdraft facility. Proactively manage your relationship with your lender. Banks make money by lending money—they want you to prosper so they can continue to lend you money.

If you do need to go back to the bank for help or additional borrowing, discuss the best approach with your professional advisers. Draw on their knowledge and independence to improve the credibility of your plans.

If you are looking to re-finance, also consider alternative sources of finance. An asset-based lender may enable you to leverage more funds out of existing assets. If you are importing, there may be trade finance, or stock finance available.

What can be avoided?

Don't fall into the trap of thinking that it is up to the bank to guide you through any issues or problems. If you talk to your bank early enough, they may work through the problem with you, but be very clear that the ultimate responsibility for resolving any issues falls squarely on management's shoulders.

Do your best not to break any loan agreement provisions that might trigger a technical default. Also, do your best to stay current on your debt. In the end, you are trying to ensure that your company has the financing availability to operate the business effectively. You will clearly want to avoid having your credit facility restricted.



07

Keep an eye out for bargains

Be alert to opportunities where business valuations are falling and where business owners are looking for quick exits rather than risking survival through a difficult economic period.

What's the issue?

As lending markets contract, some companies will have or anticipate having liquidity problems. A number of these companies will consider a sale transaction as a viable option. It could be a need to preserve personal wealth, the real or perceived lack of alternatives, or a lack of confidence in a recovery. This feeling of uncertainty will drive many shareholders to seek an exit or a partnership with a strategic investor rather than hunkering down and trying to weather the storm independently, thus creating buying opportunities at depressed prices.

The mid-market is still fuelling M&A activity. A recent survey of 600 owners and managers of privately held businesses by Grant Thornton UK shows that, while the mega deals may be drying up, ambitious and well-funded companies continue to see the value of strategic acquisitions and are picking up bargains to supplement organic growth. In South Africa we are experiencing the same trend. An increasing number of private companies with access to funding see huge opportunities for expansion in the current climate. It is likely that there will still be funding available for the right proposition.

What can you do?

Well-funded companies looking to add market share, expand product / service offerings or recruit quality people might find it less expensive to acquire targets that

fit this criteria than it would be to invest internally to try to achieve these goals organically.

The same limited access to capital that pushes some companies to sell will keep on the sidelines other companies that would have been suitable buyers in a normal lending environment. Additionally, traditional leveraged buyout funds will have more limited access to the “leverage” that allows them to consummate transactions at targeted returns.

The result will be less competition for attractive acquisition targets and thus, potentially reduced pricing multiples on acquisitions. A professional adviser can increase exposure to such opportunities, while ensuring transactions are priced and executed in an effective, cost-efficient manner. Whether you are playing the stock market, engaged in real estate or considering acquisitions, the best buys are made in a down market.

Be alert to opportunities where business valuations are dropping and where

business owners are looking for quick exits rather than trading through a more difficult economic period.

Take professional advice to ensure you make properly assessed, targeted acquisitions that will take your business forward.

What can be avoided?

Do not make an acquisition just because you can. Good acquisitions are part of a well-thought-out growth strategy, combined with proper transaction execution and integration. Failure to approach acquisitions objectively can prove fatal.

More importantly, this is not the time to become distracted. Remain absolutely focused on the day-to-day running of the business. Be mindful of debt capacity, and don't over-gear the business. This is not the time to become distracted. Remain absolutely focused on the day-to-day running of the business. Be mindful to debt capacity and don't overstretch yourself.



Re-visit your strategy

Make sure you understand your core capabilities, the strengths of the business and where your best opportunities exist. This clarity of focus will enhance your ability to take advantage of opportunities as they emerge.

What's the issue?

Tough trading conditions will demand a clear strategy, combined with focused and relentless management to implement that strategy. When market conditions change rapidly, you can't assume that your existing product and market strategy will continue to be successful. Changing market conditions can often be a catalyst for revisiting difficult strategic decisions.

This is not the time for your strategy to drift off course, but equally you may need to stop and think, and take a fresh look at your business.

What can you do?

Make sure you understand your core capabilities, the strengths of the business and where your best opportunities exist. This clarity of focus will enhance your ability to take advantage of opportunities as they emerge.

Having the right business to go forward may require the disposal of non-core assets and business streams. Non-core business streams can consume much needed working capital and the sale will also generate cash.

Combine available market research with existing financial information on year-on-year performance and comparisons with budget. Determine which product lines, sectors and customers are likely to put pressure on your

profitability, and which present the better tactical opportunities in the short-term. There is no better time to review business performance in this way, as it will help you to focus on your resources more effectively.

If you have liquidity or access to investment funds, look at acquiring assets, expertise or a local competitor.

In uncertain times, trade barriers can retrench or relax depending upon the government, creating new opportunities that you may have discounted previously. Similarly, shifts in the currency markets can quickly create a better environment for exports.

What can be avoided?

Although it is important to test assumptions and re-visit strategy, don't feel that you need to change your whole business model overnight. If your strategy is sound, continue to manage effectively and stay the course.



09

Align performance and awards

Changing rewards structures is clearly a slower burn than immediate cuts, but it can strengthen a longer-term position and can demonstrate that management is taking positive action.

What's the issue?

Align your people. Motivation can take a hammering when business is lean. Once you've defined your key objectives out of strategic planning and zero-based budgeting exercises, you need to make sure staff understand and are rewarded for achieving those objectives. Ensure everyone knows the strategy and repeat it often. Align every aspect of reward to achievement of your goals.

What can you do?

Think about the behaviors you want to encourage. Consider the 'golden thread' running from strategic objectives right down to individual objectives and remuneration.

Think about rewarding sales teams based on profit per unit or speed of cash flows rather than simply on units sold. Alternatively, only start paying bonuses once minimum cash flows have been achieved.

What can be avoided?

If you have a bonus culture, and the cash simply isn't there to make bonus payments, you have to be completely transparent and communicate effectively to explain the position. Consider alternatives, such as deferred share arrangement to encourage staff to stick with you through the downturn.

Protect your personal wealth



What's the issue?

The problems in the financial sector of the stock market clearly demonstrate the need for diversification. Diversification is equally important when considering additional business investments or personal guarantees in a business.

In our current economic environment, it is likely that businesses will have greater borrowing needs. In this environment, banks will want more security in the form of personal guarantees, additional collateral and more stringent debt covenants, even on existing loans. Solving business cash needs with personal assets will reduce the diversification of your overall personal net worth and further expose you to a long-term recessionary economy.

What can you do?

Before you agree to become more personally exposed for the sake of the business and less diversified personally, think hard about your options. While you may be emotionally (and financially) tied to the business, now is not the time for emotional decisions. Can the business survive a long-term recession? What will you do the next time the business needs cash?

Before you agree to become more personally exposed for the sake of the business and less diversified personally, think hard about your options.

Do not think just in terms of debt. Borrowing may be the quickest form of cash, but if it comes with additional security requirements or personal guarantees, think about the ramifications of having all of your eggs in one basket in a risky economy. While you may not like the idea of additional owners in your business, equity financing may be a safer alternative and provide you with additional resources if the economy does not improve as quickly as you expect.

If you decide debt financing is the best course, avoid, where possible, personal guarantees and pledges of personal assets to secure business debts. Employ experienced counsel to help with the transaction. Understand the financial ratios of the business, and make sure there are no opportunities for technical default of the loan guarantees that will trigger the personal guarantee. Be sure the personal guarantee will not destroy your personal wealth outside the business. A smaller guarantee may mean less money available to the business, but it means less personal risk. Having to sell your business is a change in your life. Having to sell your house is life changing.



What can be avoided?

Throwing good money after bad.

The US credit crisis: What happened and how it impacts you

Most people are generally aware of the major events in the US—and indeed globally—during the past year, beginning with the sub-prime crisis through the failure and overnight sales or rescues of major Wall Street and European banks, to the more recent breakdown in the credit markets that has necessitated major government intervention.

Years of gearing-induced, high growth were spurred by easy credit, covenant-lite loans, record consumer spending, housing speculation and exotic mortgages. This set the stage for unprecedented home ownership levels and securitisations of assets by financial institutions feeding the voracious return objectives of hungry investors. The system worked until the economy softened, housing prices began to fall, mortgage foreclosures and losses mounted, and fear started to creep in as doubts were raised about the ability of borrowers to service debts. As the prices of residential mortgage-backed securities and related complex derivatives fell sharply, investors turned abruptly away from assets in the secondary market, leaving many of them without a bid. With liquidity evaporating, a sudden flight to safety caused a rush to hoard cash—buyers stopped buying, lenders stopped lending, and mark-to-market accounting rules governing certain balance sheet assets resulted in sharply rising losses at financial institutions and, thus, a further reduction in the availability of credit.

Despite global government intervention, credit markets are anticipated to remain tight in the intermediate term. Banks continue to hoard cash while trying to eliminate or write down risky mortgage-related loans from their balance sheets.

What to expect in the global credit markets going forward?

Despite global government intervention, credit markets are expected to remain tight in the intermediate term. Banks continue to hoard cash while trying to eliminate or write down risky mortgage-related loans from their balance sheets. Meanwhile, inter-bank lending has dramatically declined, resulting in lower liquidity and higher funding costs for banks.

What does this mean for the typical South African business owner?

With their generally more conservative approach and stronger regulatory safeguards, South African banks have not been as heavily impacted by the sub-prime lending crisis as the US banks.

Notwithstanding this, securing new debt or refinancing/extending current credit facilities has become increasingly difficult. Today, debt is still available, but banks and investors are looking for higher-credit-quality issuers with greater protection against loan defaults. In addition, debt providers are looking for increasingly

larger premiums to compensate them for the risks related to extending credit. Accordingly, borrowers can expect increased borrowing costs.

Additionally, lenders are increasingly requiring added credit enhancements such as personal guarantees from business owners, and most importantly, stronger covenant packages with greater restrictions on total gearing levels and increased cash flow coverage of interest, fixed charges and debt service. Meanwhile, uses of borrowed funds are also being closely monitored, with substantial restrictions on dividend distributions and owner salaries.

Lenders have also tightened advance rates on collateral to provide an additional cushion in case pledged assets decline in value in today's volatile market environment. Along with these reduced advance rates, borrowers are experiencing increased financial reporting requirements in the form of more frequent submission of borrowing bases or financial statements to lenders.

Many business owners are being forced to consider non-traditional financing sources such as sale leaseback arrangements, greater reliance on leased equipment, just-in-time inventory management, and sales of assets such as factoring of accounts receivable to supplement their liquidity or financing needs.

Business owners and managers are increasingly working with their bankers, accountants and consultants to figure out a rational and appropriate investment strategy.



Diagnostic questionnaire

Consider the following questions. An affirmative response to a number of questions could be indicative of a company experiencing financial and/or operational distress.

Financial

- 1 Is a “going-concern” qualified from your auditors a possibility? Y N
- 2 Has revenue decreased by more than five percent during the last 12 months? Y N
- 3 Has gross margin decreased during the last 12 months? Y N
- 4 Has the company’s operating cash flow (EBITDA less capital expenditures) decreased in the last 12 months? Y N
- 5 Has the company’s cash collection cycle increased in the past 12 months? Y N
- 6 Has the quotient of average inventory divided by annual sales increased by more than 10 percent during the last 12 months? Y N
- 7 In the last 12 months, have vendors increasingly demanded cash on delivery or reduced credit terms? Y N
- 8 Did utilisation on revolving credit exceed 85 percent of availability in the last 12 months? Y N
- 9 Has the company violated the terms of its borrowing agreements or breached debt covenants in the last 12 months? Y N
- 10 Is the company highly geared relative to industry competitors? Y N
- 11 Has the company’s debt credit rating been downgraded, or has its debt traded at a discount over the last 12 months? Y N
- 12 Does the company expect to have difficulty meeting scheduled principal or interest payments? Y N

Management / Organisational

- 13 Has there been significant turnover among the senior management team? Y N
- 14 Is management reactive rather than proactive in solving problems? Y N
- 15 Has the company not produced a monthly financial plan (including projected income statement, balance sheet and cash flow statement) in the last 12 months? Y N
- 16 Has the company not prepared a strategic business plan in the last 12 months? Y N

Sales / Marketing

- 17 Did the company lose market share in the last 12 months? Y N
- 18 Have any new entrants captured significant market share during the last 12 months? Y N
- 19 Have there been major delays in launching new products? Y N
- 20 Are the company's sales highly concentrated among few customers? Y N
- 21 Is it fair to say the company is not deeply familiar with the credit profiles of its major customers? Y N

Operations / Production

- 22 Is there over-capacity in the company or its industry? Y N
- 23 Is the company's technology lagging? Y N
- 24 Have customers cited an increasing rise in quality problems in the last 12 months? Y N

Worst-case scenario

Call professional advisers far in advance of a financial crisis, if at all possible. The more time you have to identify your options and craft a plan, the better your chances of success.

What's the issue?

You've taken a hard look at your business and stress-tested sales assumptions, but your fixed costs are such that even breakeven cash flows are based on certain levels of revenue. Your balance sheet is highly geared relative to your competitors. Your future is uncertain, and trade credit is contracting. You've produced short-term cash flow forecasts and your current outlook is negative, and you foresee a serious liquidity crisis looming in the near term. A payment is due on bank or bond debt, liquidity is waning, and a default is imminent. Bond debt is trading at a deep discount, so a capital infusion is unlikely.

What can you do?

Don't panic. The credit crisis and economic downturn are impacting businesses globally across almost every industry, so you're not alone. Carefully consider strategic alternatives. What are the advantages and disadvantages of restructuring a business through insolvency? Does a sale of all or part of the business make sense? Is raising equity an option? What is the enterprise value of the business, and is that value greater than the face value of secured debt? How do you determine the value of all or part of the business? In a financial restructuring, the critical issue is indicative value.

Look at your business without its existing debt, and determine its debt capacity based on your most current financial projections. There are two fundamental approaches to determining debt capacity: leverage multiples and coverage ratios. Both are highly dependent on market conditions. Lenders and debt investors also look at alternative exit strategies, including the liquidation value of collateral and tertiary sources of recovery such as personal guarantees. Understand your bargaining position and your views on value. Consider your fiduciary responsibility. If you are operating in the “zone of insolvency,” your responsibility is to creditors, not to shareholders.

What can be avoided?

Do not, under any circumstance, wait until you are almost out of cash. Build cash reserves and hire professionals who can help you assess your options. Don’t assume the problem will go away over time. In most cases, doing nothing will cause value to erode rapidly. If possible, defer conversations with banks and bondholders until a full game plan is developed. Do not agree to provide additional collateral or a personal guarantee in exchange for covenant waivers, until you have fully assessed your options.



Contacts

Further advice

We are here to help. For further information and advice based on the specific issues facing your business, please contact our Grant Thornton business advisory team.

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