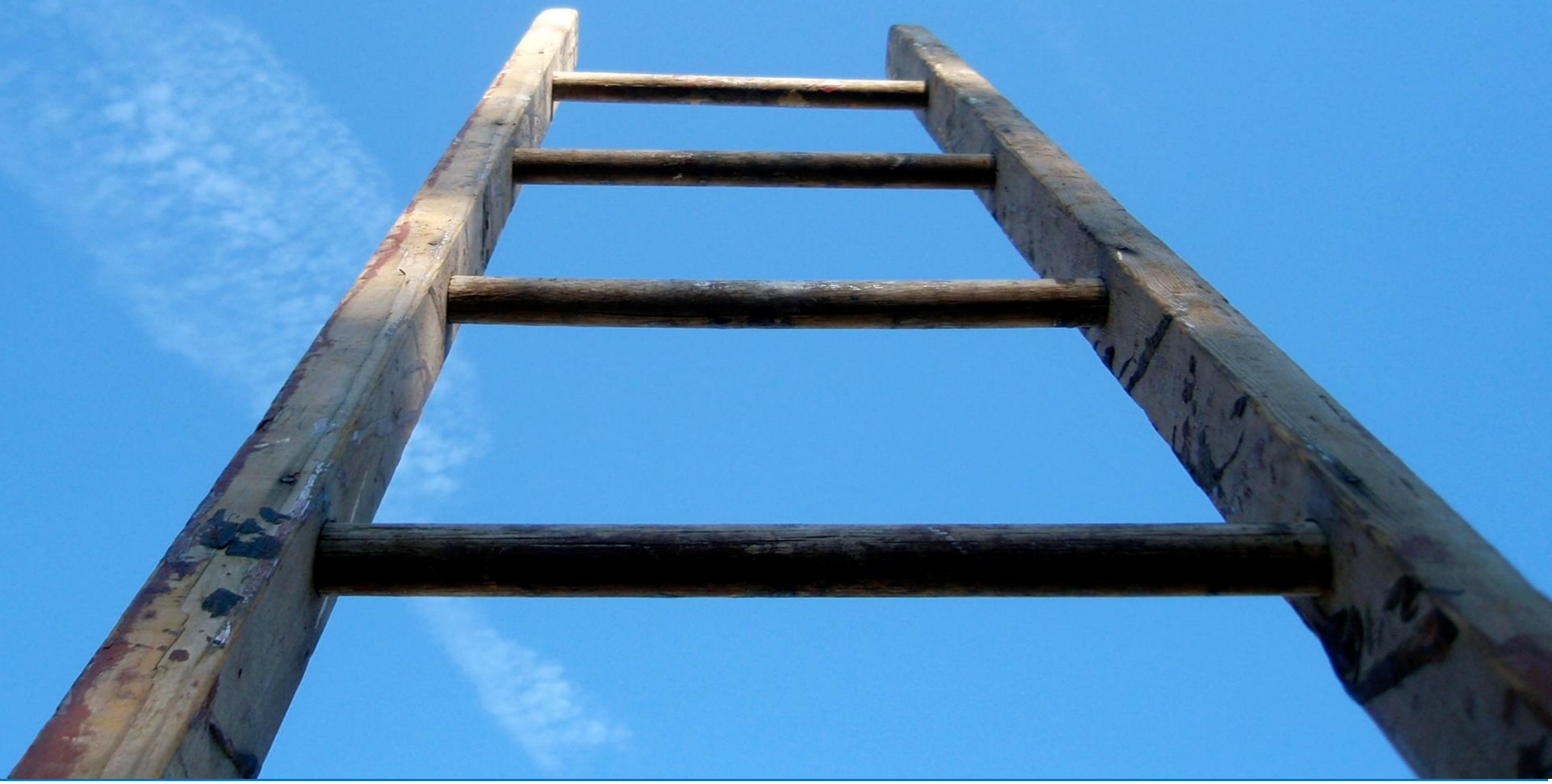
Distressed Business Solutions

Business Rescues - Turnarounds - Workouts - Coaching

By Ivan Uttley: Senior Rescue Practitioner

This is the output from a 3 day Reasonable Prospect Assessment of Company X – 1 off site, and 2 onsite with the business.

This is a SUMMMARY document for presentation and discussion purposes, and should not be used without first understanding the mechanics of the spreadsheet which are summarized with here,



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Document Structure & Contents

The document is structured in four sections with accompanying attachments

1. Section 1: - Summary Findings and Executive Summary of Issues and Rescue Prospects
2. Section 2: - Quantitative review of Financials and Rescue prospects.
   - Assessing BRiL (Better Return than in Liquidation (S128(1)iii)
   - Quantifying the need for PCF (Post Commencement Finance (funding)
3. Section 3 – Qualitative Assessment
   - Accounting for PI (Public Interest)
   - Practical Consideration in implementing a rescue plan (skills, costs and alignment)
4. Section 4: -Appendixes : Supporting documentation
5. The Quantitative Detail and Business Self Assessment are attached as a separate documents:
   - ENS-Firm-X-Prospect-Analysis.xlsb
   - ENS-Reasonable-Prospect-Quality-Scoring.xlsb

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Preamble – Successful Conclusion of Assessment

The Assessment, has been able to conclude within the 5 working days stipulated by the Company Act:

1. It began on x Month Year, on the requested appointment of xxx
2. An immediate data request was made which sought the latest audited Income Statement, Balance Sheet and Cash-flow statement, to be used in the prospect assessment worksheet – see Attachment A.
3. A second very exhaustive request was made for the following to be available on site: On site preparation - follow this link, please.
4. The financial data was immediately forth coming, and the assessment began with the usual desk-top study which took one day.
5. The assessment then moved on-site to the business and was concluded within 2 days.

We have been able to gather sufficient information and have had adequate access to management and the leadership team to form an opinion on the following:

- An assessment of BRiL (Better Return than in Liquidation (S128(1)iii)
- Quantification of the PCF requirements (Post Commencement Finance (funding))
- Public Interest Considerations - PI Score
- Practical Consideration of implementing and delivering the rescue plan. (human capital)

We see compelling evidence of actual financial distress, but excellent prospects for rescue with returns significantly exceeding those expected from an insolvency process with only marginal extra risk, but considerable Public Interest benefit. We endorse this rescue planning phase and expect a plan to meet with approval.

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No show stopper concerns have been raised with regard to any of the following Red Flags

Red Flag Consideration	Status	Supporting Comments
Shareholder Alignment		Although a degree of animosity and discord exists, there is consensus on key issues and decision making should not be an issue
Shareholders transparency		Shareholders have been co-operative and transparent
Intent of Rescue		The intent seems genuine and there appears to be a sense of urgency and a desire to meet debt obligations
Availability of data and its accuracy		Some of the data one might expect is absent and there are some doubts on the reliability of parts of the data.
Signs of fraud or illicit practices		None of the rumors about preferential procurement or 3rd party contracts to family members could be substantiated. Will monitor
Nepotism		Family members do exist but they seem to be competent and a degree of meritocracy exists.
Company loans to directors		None, no issue
Flight of Talent		No people Plan is in place to deal with retention of key Staff (nor is there any plan that deals with the broader key Headcount considerations, however as an alternative a capacity plan has been agreed in principle with the main union.

Confirmation in writing on the issue of preferential procurement has been requested in writing from the leadership team.

Section 1- High Level Prospect Assessment Methodology

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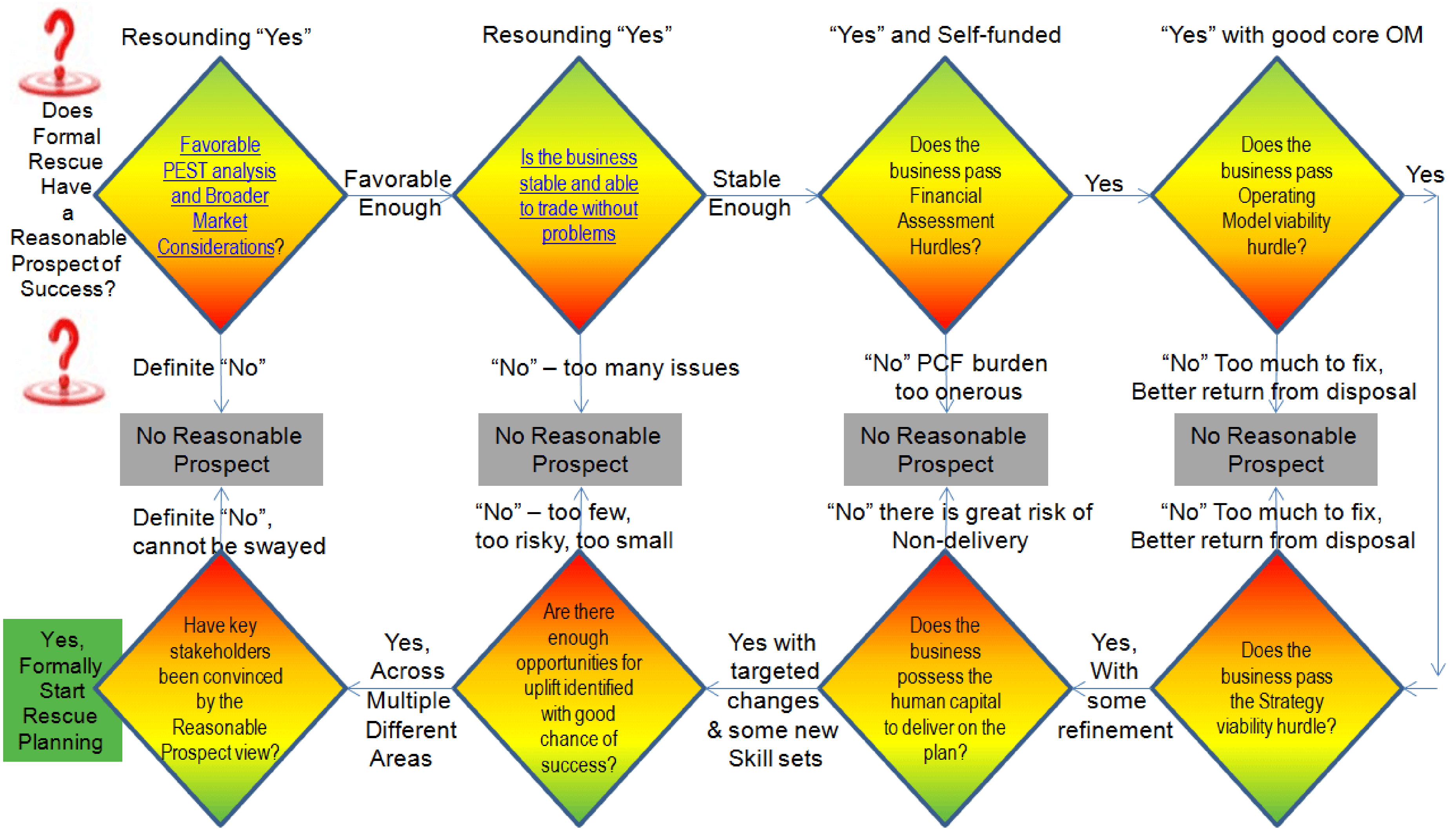

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Section 1 – Methodology Stage Summary (refer to Appendix A)

Methodology gate	Status	Supporting Comments
Market & Industry		The piping system industry (also referred to as liquid and gas transfer), is a remarkably robust industry as it is a supplier to Heavy Industry (ie Mining), Agriculture and the Building industry. There are healthy 2ndary markets providing specialist services, (high pressure, toxic gas) and the diversification is a strong mitigant against cyclical downturns. There are no dominant players, and the Cr3 and c10 stats point towards a healthy competitive market with no room for predatory pricing.
Business Stability		The utility, and 3rd party suppliers, as well as SARS have voiced their support. Because the business is multi-banked there is the risk that foreign exchange credit notes will be withdrawn or perhaps capped. Discussion have been started on consolidating all banking and insurance to a single institution who will then co-operate.
Financial Viability		This is a financially distressed business, but there is strong evidence to support a restructured entity will be financially viable and in fact to a great degree dispense with PCF. It is our opinion that this business has outgrown its leadership team, and the recent acquisition , perhaps strategically sound (although the evidence of structured, planned and well considered thinking is absent , and seems opportunistic – not always bad!) has proven to be a key contributor to the current crisis. The attached assessment analysis substantiates the financial potential of this business
Creditor Stakeholders		Second most significant lender – on CPF, is very hesitant about post commencement financing, and has voiced a near willingness to foreclose. They have consented to a gated rescue implementation, and insist on 2 management changes. These are not unreasonable demands.

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Methodology gate	Status	Supporting Comments
Operating Model		As alluded to, the recent acquisition was made upon a business that lacked a structure that was scalable, and poorly understood (the management data is poor) isometric scaling attributes have become led to Operational expenses and Overheads which are clearly out of line with the rest of the industry. At the same time COGS has also not tracked in a scalable manner, most likely it would appear because their growth has led to serious quality issues leading to recalls and expensive rework.
Business Strategy		No evidence of any link between aspirations, and actual targets, with integration of Strategy, Planning, Execution & Tracking evident. There is no alignment within the business, and no consistent view on a clear, simple set of strategic goals that the entire business is working towards. No part of the income statement is owned, and hence no accountability towards any key financial outcomes,
Human Capital		Some serious gaps in terms of competence at the leadership level, although there is no doubt that good intentions and strong value systems have compensated to a degree. Within the business itself there seems to be pockets of excellence with great energy and a clear sense of urgency. Some parts of the business seem toxic but this may be a symptom of frustration and the under-performance and lack of consequence management. The business self-assessment has shown clear alignment and consistency of well recognized issues, and despite the absence of a "people plan", talent does exist in this business.
Turnaround Opportunity		Very clear opportunity is present and one which will not demand and risky revenue growth. There are clear uplift opportunities which should be close to immediate ion terms of impact. Please see attachment A

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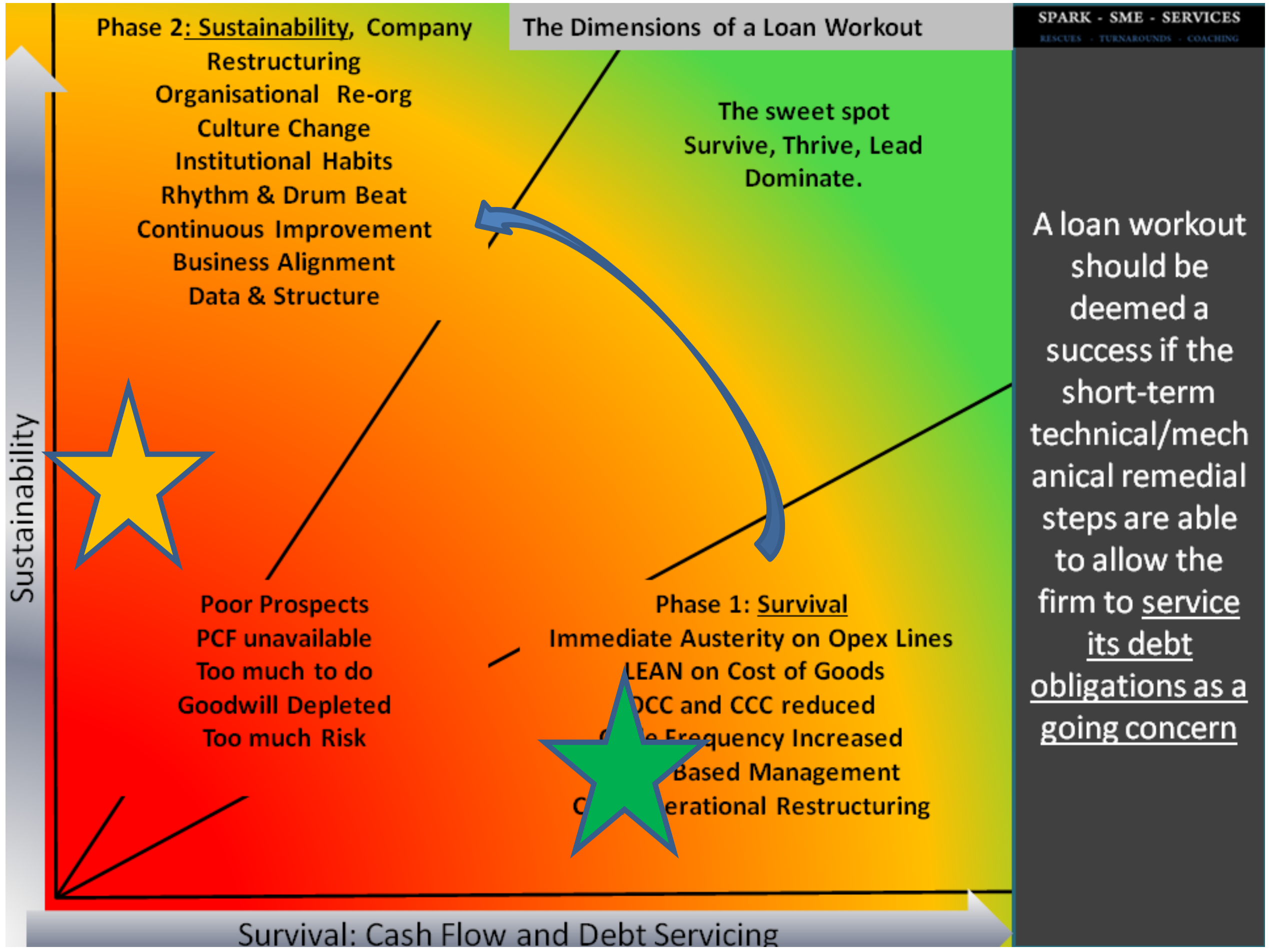
Sustainability: How to avoid this occurring again. Address the 4 underlying causes that led to failure.

Position the business to create its own nightmare.

The later stages of the rescue will be emotionally taxing, potentially acrimonious, but are necessary.

Habits, Communication and Alignment will have to be addressed immediately..



Initial Focus: Cash, Servicing Debt, striving for a Self-funded plan, understanding non-linear multipliers – there is every possibility of the business meeting all its debt obligations on a properly discounted NPV basis.

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Contents

The document is structured in three sections:

Quantitative Prospect review – refer to Attachment A

Balance Sheet for FY year: =Audited 2015 in '000s					
Assets	**ZAR amount in (000)**	**Equivalent Days**	**Liabilities**	**ZAR amount in (000)**	**Equivalent Days**
Liquid Assets-Cash, Stock, Assets on Sale	78,318		Accounts Payable	362,141	<- Calc A
Accounts Rec	325,645	<- Calc B	Current Loan + overdraft	135,614	
Inventory	482,590	<- Calc C	Bal of Current Liabilities	31,736	
Bal of Current Assets	26,602		Non-Current Liabilities	584,294	
Bal of Non-Current Assets	842,398		Equity	1,317,256	
Plant & Equip	675,488				
Total Assets	2,431,041		Total Liabilities	2,431,041	

	Audited 2015 in '000s	Income Statement	
IS Lines	**ZAR amount in (000)**	**Day Equivalent (in '000s) Burn Rates**	**Ratio**
Revenue/Income	2,327,394	6376	100%
Cost of Sales	-1,836,226	5031	-79%
Gross Profit	491,168		21%
Op. Expenses	-459,826	1260	-20%
PBIT - Operational Profit (ie excl non-recurring income)	31,342	86	1.3%

Immediate insolvency would still incur risk and this is time line as well as WACC dependent.. Estimates, depending on 3-6 &12 month time horizons value the outcome at 63-76 cents on each Rand of outstanding debt.(capital + remaining interest, using discount rate of prime + 5, higher WACCS are obviously penalized.)

The latest Audited Financials confirm the financial distress, and the YTD actual vs. Forecast is misaligned. On the current trend the business will again miss its own forecasts. (not a unique occurrence). Some concerns are obvious (OpEx as % of Rev,) and the PBIT of just under 1.5% and COGS on an historical trend has increased disproportionately with revenue growth.

Quantitative Prospect review – The Current Economic Engine

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The Current Economic Engine Story		
To generate	100.0	cents of Sales, from which
the business makes	1.35	cents of Free Cash Flow
the business needs	50.1	cents of Working Capital.
Indicating a per cycle	2.7%	Growth Rate
And with each cycle taking	147	Days
We have	2.48	Cycles per year
Thus 0% inflation self-funded growth is	6.8%	per year
and accounting for inflation @	6.1%	(perhaps even too low)
Our real Self funded growth rate is	0.7%	per year

The current Economic Engine Story with debt & WC delta obligations		
To generate	100.0	cents of Sales, from which
the business makes	0.05	cents of Free Cash Flow
the business needs	50.1	cents of Working Capital.
Indicating a per cycle	0.1%	Growth Rate
And with each cycle taking	147	Days
We have	2.48	Cycles per year
Thus 0% inflation self-funded growth is	0.2%	per year
and accounting for inflation @	6.1%	(from our estimate above)
Our real Self funded growth rate is	-5.9%	per year
whilst covering the WC Change by	ZAR 30,256	for the year
Our Change in WC Gap is	ZAR 21,256	for the year
Our Debt repayment capacity is	ZAR -	for the year
Our Debt Repayment Gap is	(ZAR 41,262)	for the year
If we have real growth, after funding debt obligations as well as changes in WC,then we have a going concern! This is not the case currently		

The current performance can barely self-fund growth to keep abreast of inflation (remember the costs are inflated before the income is generated! And if we consider the stated change in Working Capital that must be funded as well as servicing debt then we have a business that meets every definition of financial distress

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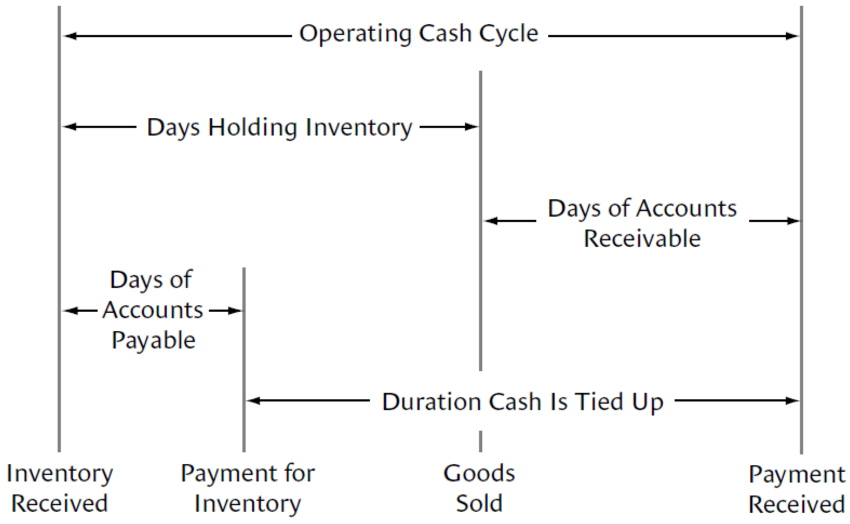
Quantitative Prospect review – What is hidden



Current Audited View	Unit	Item	Uplift benefit
72	Days	Days Accounts Payable	Maintain for the moment
51	Days	Days Accounts Receivable	6 days
96	Days	Days Holding Inventory	4 days
147	Days	Operating Cash Cycle	10 days improvement
75	Days	Cash Conversion Cycle	
73	Days	Opex Days	
0.50		Exp-Factor	
0.51		Rev Factor	

The economic engine "story" hints at the first major issue, which translates to this. The time it takes for this business to take raw material, process it, ship it, sell it and then get cash from its customers is 147 days. It retains a huge benefit by having credit with its existing suppliers who in essence are financing 72 days of this cycle. Clearly unsustainable and conformation of the current problem. At the same time, their accounts receivable is 51 days, so they are financing their customers currently, beyond what is reasonable. Many businesses have average AR of <10 days, big customers might demand 30, but 51 days is a clear mismanagement. Sitting with the management team, we have identified low risk uplift opportunities, detailed in the uplift tab and quantified as follows: improving our cycle time by 6 + 4 days = 10 days, reducing COGS by 5.3% and Opex by 18.3%

Please refer to Attachment A, for the justification and detail behind these very conservative figures.

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Quantitative Prospect review – The what-if Economic Engine

IS Lines	(in Cents)	with CCC factoring	effective (in cents)
Revenue/Income	100.0		
Cost of Sales	-74.7	x Rev-Factor effectively is	35.5
Operating Expense	-16.2	x Exp-Factor effectively is	8.1
Total Costs	-90.9	Cash tied up per 1 ZAR of Sales Revenue (in cents)	43.5
Cash with Uplift & Remedial actions	9.1		

The potential theoretically, and indeed quite practically, as we do not consider any Revenue uplift as a benefit in this analysis, is quite clear, although previously disguised. We will now generate over 9 cents per ZAR of revenue, a 7 fold increase, and moreover each rand we have will be cycled more frequently through the business acting as a multiplier on this 7 fold increase.

The What-if Economic Engine Story with Uplift		
To generate	100.0	cents of Sales, from which
the business makes	6.8	cents of Free Cash Flow
the business needs	43.5	cents of Working Capital.
Indicating a per cycle	15.6%	Growth Rate
And with each cycle taking	137	Days
We have	2.66	Cycles per year
Thus 0% inflation self-funded growth is	47.3%	per year
and accounting for inflation @	6.1%	(from our estimate above)
Our real Self funded growth rate is	41.2%	per year
whilst covering the WC Change by	ZAR 11,637	for the year
Our Change in WC Gap is	ZAR 2,637	for the year
Our Debt repayment capacity is	ZAR 41,893	per year
Our Debt Repayment (Gap)/Excess is	ZAR 631	per year (before non-recurring!)
Just by removing a bit of cost in COGS, reducing Opex by a reasonable amount and CRUCIALLY making sure we increase the multiplier on the uplift by increasing the Cash Cycle, then we can rescue the business.		

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Additional Considerations to be covered in the Planning

These Minimum Considerations will be further leveraged in the Plan:

a) Continued Business Stabilization and Austerity Measures (covered in the ~20% reduction

b) Tactical self-funding initiatives – as we have proven in the numbers

c) Strategic Review

d) Operational Restructuring

e) Company Restructuring

a review of core operations and product as well as consideration of divesting non-core parts of the value chain to better suited 3rd party providers should add value, for example. This business has no competency in managing their call centre, which is expensive and also sub-standard in service metrics. This should be divested and outsourced, as an obvious starting point.

a) Financial Restructuring

b) Debt Refinancing

Refinancing and restructuring will only commence once we have finished these first stages, (if all all even necessary) it would be ill-advised to do so beforehand as we believe the information that will guide valuations, decisions and attract alternate investors (mezzanine) requires the data output from these initial steps. However the business remains open to all considerations.

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Reasonable Prospect - Analysis & Uplift Opportunity

Quick Overview

The Reasonable Prospect Assessment provides guidelines for improving quality issues within an organization. 91 criteria are evaluated and scored for assessing overall quality performance within the organization. The 91 criteria fall into 7 categories, as summarized below, these are an excellent proxy for assessing the organisation's ability to address all line of the income statement, and to do so with urgency and attention to detail, as the crisis demands.

	Maximum Score	*Your Assessment Score*	*Percentage*
1.0 Leadership	95	21	23%
2.0 Information and Analysis	75	22	29%
3.0 Strategic Planning	60	13	21%
4.0 Human Resource Capital	150	59	39%
5.0 Process Management	140	105	75%
6.0 Quality and Operating Results	180	81	45%
7.0 Customer Satisfaction	300	204	68%
Total Points	1000	506	51%

Color Scoring:

- Good overall score
- Caution - Opportuity to improve
- Poor - Big Opportunity for improvement

Color Scoring

Your percentage scores are highlighted in one of three colors:

Good Score falls in a range between =>	70%	100%
Caution falls in a range between =>	50%	69%
Poor Score falls in a range between =>	0%	49%

The Self Assessment of the Key domains of Leadership, Data & Information, Strategy & Planning, Human Capital, Process Management, Operations Management and Voice of Customer, show remarkable consensus even within the existing leadership team. The data is the aggregate feedback of the leadership team, their direct reports, and again theirs in turn. 47 responses. The issues are quit apparent, and this is why a gated plan is recommended.

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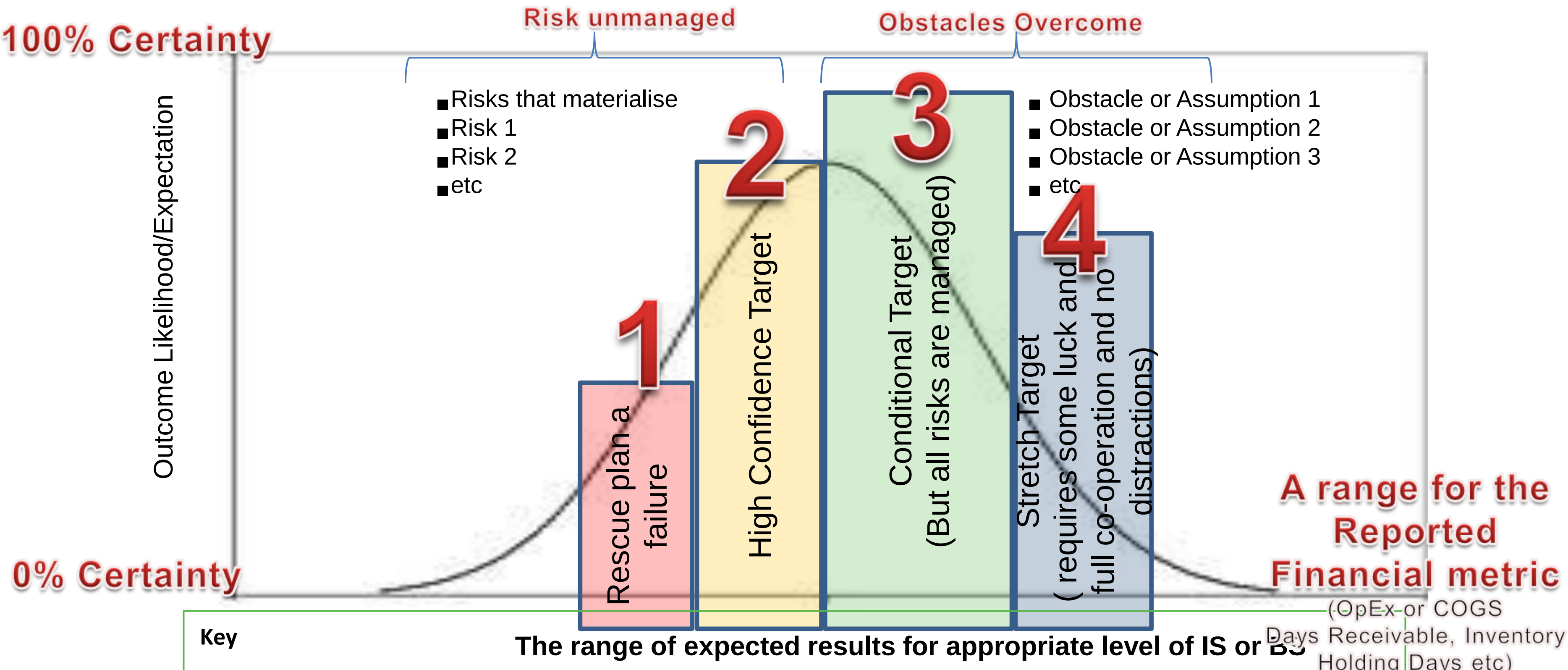

Key

Shaded area 1 – Shows unmanaged or unavoidable risk hampered delivery of the expected result.

Shared area 2 – Very confident of meeting at least this target

Shaded area 3 – Conditional Target, which requires certain conditions

Shaded area 4 - Stretch Target – but not beyond the realms of the impossible – we will strive for this.

R - Documented Risks/Issues that will prevent us reaching this benefit

O - Documented Obstacles that we must overcome to get the Stretch

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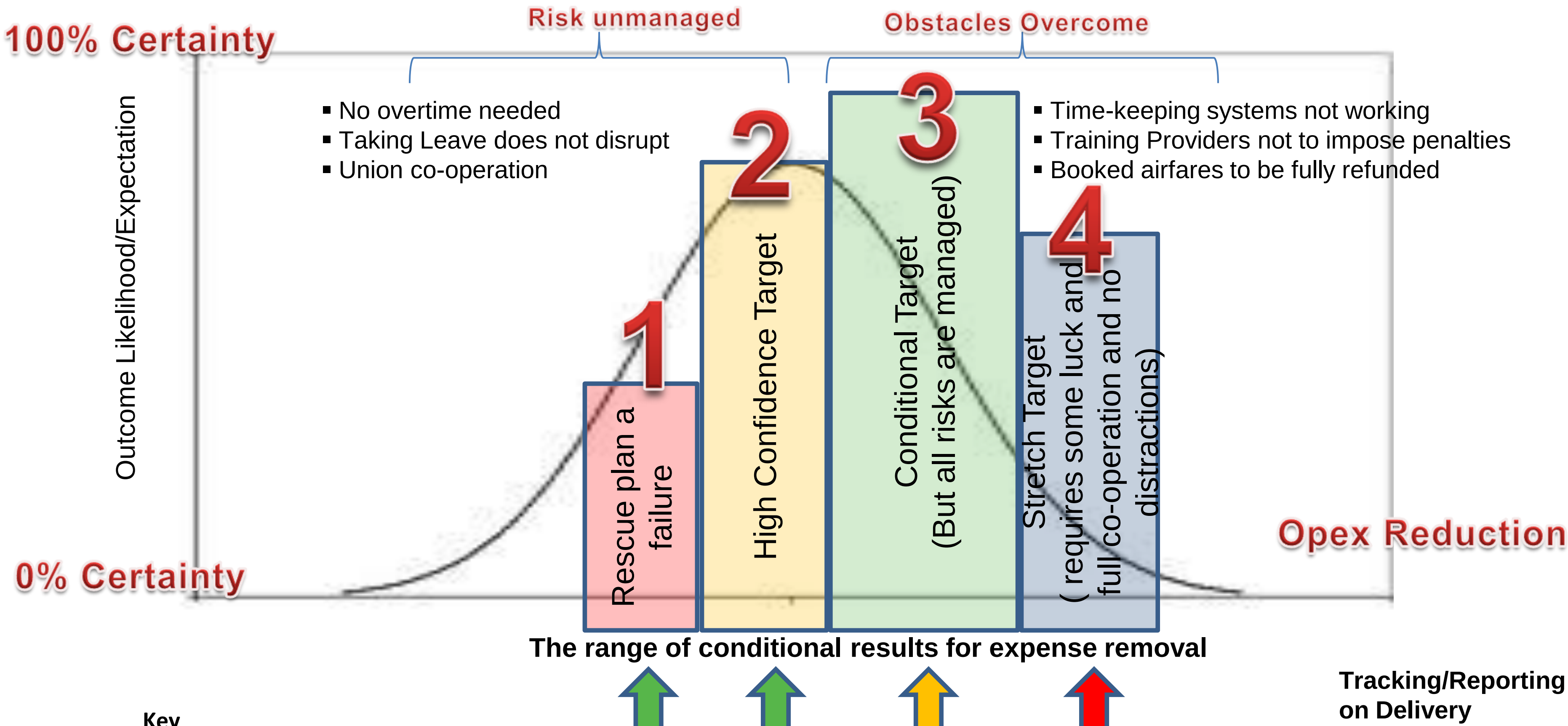
Reasonable Prospects: Opex Uplift – Actual Reporting and Commitment



Key

Shaded area 1 – Shows managed risk dealt with is 15% reduction – bank on this.

Shared area 2 – We should reduce expenses 18% – no reason to miss this target.

Shaded area 3 – We could reduce expenses by 23%, but this requires A & B to happen

Shaded area 4 – We are aiming for 31%, but this requires C, D & E to happen

Tracking/Reporting on Delivery

- Unlikely
- At risk
- Bank it

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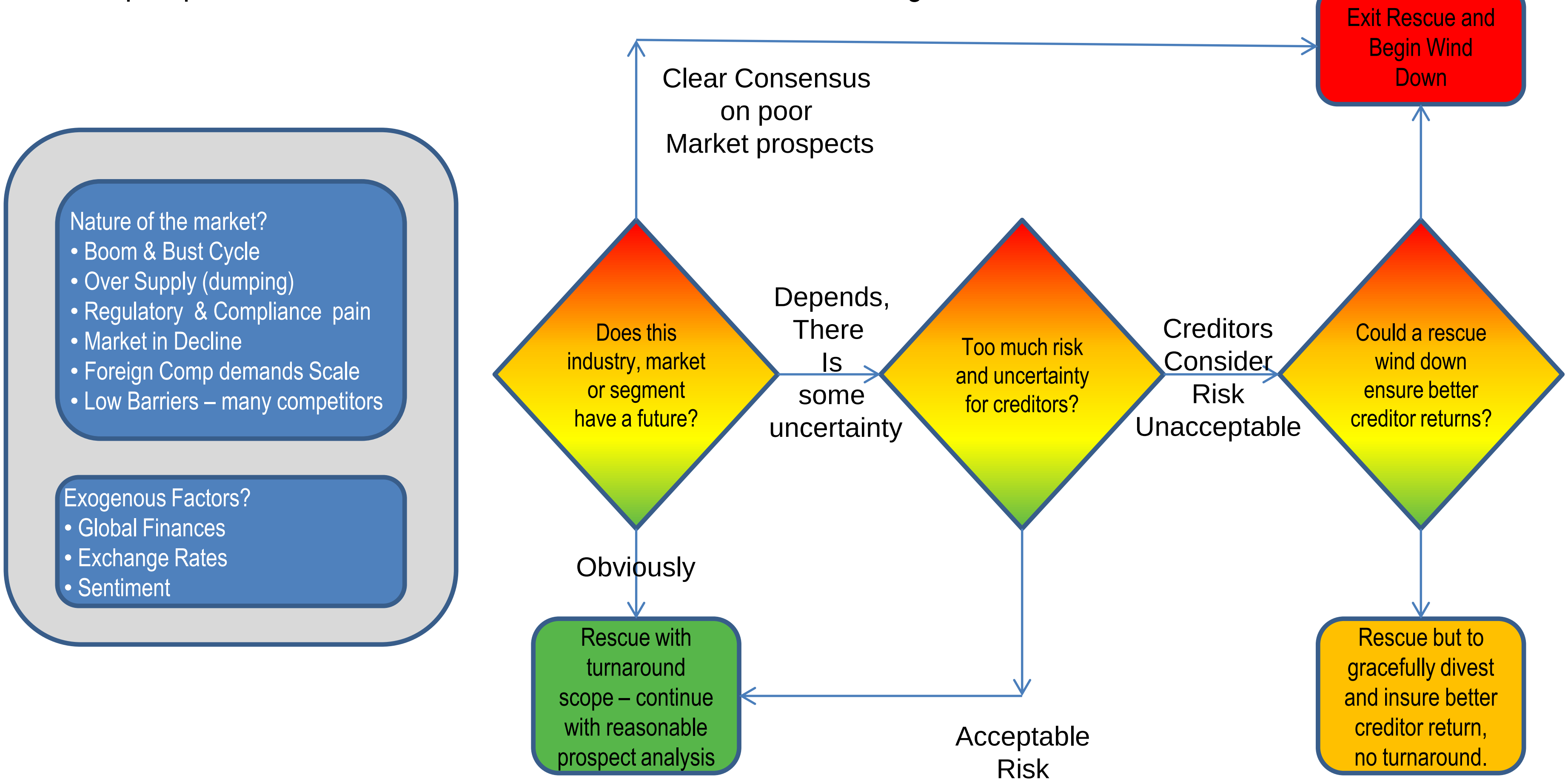
Reasonable Prospect: Assessing The Market

Some markets have brighter prospects than others, some like commodities, are price takers by definition, and some require scale to compete. Some are dying and some have fantastic prospects. Beware of the false comfort in consensus thinking*



* do not rush this decision! Keep away from lawyers and insolvency crew. Allow for LBO FPSB, MBO SBSP

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Reasonable Prospect: Key Considerations

Stability issues? What efforts are needed to ensure business continuity?

What is the quality of thought leadership & strategy?

To what degree is austerity in place, are there opportunities for further uplift?

<u>Business Stability? How deep is the crisis?</u>
- Transactional account issues?
- Over-draft facilities withdrawn?
- Enough Working capital to run basic ops?
- Supply Chain Disrupted?
- Operational Breakdown?
- Outsourced operations withdrawn?
- IP and operating license rescinded?
- Legal wrangles?
- Utilities cut?
- Key positions vacant?
- Flight of talent?
- Labour disruption?
- Flight of customers?
- Regulatory license revoked?

<u>Strategy – Is the thinking robust?</u>
- What are the words you own in the mind of the market?
- What are your Brand Promise components?
- Who are the Core Customers, &
- What is your Core Product or Service?
- Why do customers buy your product use your service?
- Does advertizing show understanding of target segments?
- Is there any customer concentration risk, historically?
- What is considered non-core business?
- Has the business strategy emphasized diversification?
- What is key to your business making money?
- What Obstacles exist to making money?
- How is your business differentiated from the competition?
- Is there any competitive advantage?
- What is the industry choke point?
- Is there a good understanding of all market forces?
- Strategic ambition exceed business abilities?

<u>Austerity measures implemented?</u>
- Lvl 1 - Refer to check list-training, travel, etc
- Lvl 2 – Senior Entitlements – memberships..
- Lvl 3 – Sunk cost fallacies – Projects
- Lvl 4 – Lean Philosophy in place

Austerity tracked and all expenses either:
1. Totally removed
2. Signed-off by executive
3. Included in latest budgeting

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Reasonable Prospect: Key Considerations

Is there requisite awareness & alignment in the business?

Are there Operating Model Issues, is it at scale, are there opportunities for uplift?

What state are the BS, IS and CFS in. Are there opportunities for further uplift?

Communication, Co-ordination, Alignment
- Can all managers summarize the strategy?
- In simple consistent language?
- Can they do so in less than 90 seconds?
- Consistently?
- Does everyone know money is made?
- Does everyone have a scorecard?
- Can they measure their own performance?
- Do measures tie back to the IS or BS?
- Do the lines of business each have an IS?
- Do the lines of the IS have accountability?
- Is each IS broken down into a value tree?
- Are the value drivers in the IS owned?

Operating Model?
- What are the measures used to track scale?
- Acquisitions a substitute for organic growth?
- Have operations scaled with growth?
- How much of the value chain is core?
- What are the outsourcing arrangements?
- Outsourcing possibility of non-core value chain?
- Are processes documented and owned?
- What is the cash conversion cycle view?
- Is the data in the business reliable?
- Are distribution channels appropriate?
- Is there a culture of continuous improvement?
- Is there evidence of R&D?

Robust Financials?
- Is the Balance sheet clean? Assets at mkt value?
- Loans to directors? Inter-company loans?
- Is the audited financial report easy to read?
- Are there any off-balance sheet SPVs?
- What % of value is in non-core assets?
- What % of value is in intangible assets?
- How liquid are these assets?
- Is the BS a problem?
- Days Equiv of AR, and AP?
- Days Equiv of Inventory?
- Are costs managed and in line with competitors?
- Assess ratio analysis.

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Reasonable Prospect: Key Considerations

Authentic, Purpose driven Leadership, which inspires?

Red Flags & Disqualifiers?

Is there an Enabling Culture and Strong Leadership?

Business Leadership

- Is the leadership team present & available?
- Has leadership built succession plans?
- Is talented attracted to this business?
- Has management complementary education?
- Diversity? Age, gender, & experience
- Diversity? Education, thinking style
- Are all management meetings fully attended?
- Is there an agenda and minutes?
- How well do they know their business?
- Any industry thought leaders?
- Skip-level meeting feedback positive?
- Results of 10 finger test?
- Response to AFF as empathy builder?
- Willingness to have anonymous 360 feedback?
- Have a nightmare session assessment?

Red Flag and Immediate Dis-qualifiers

- Complete lack of urgency is
- Unwillingness to be open, share or disclose
- Evidence of fraud
- Evidence of serious crime
- Tacit acceptance of bribery/corruption
- Undeclared holdings and interests
- Entrenched legal battles
- Unreliable data
- Toxic internal politics
- Mystery shopping misery.
- Belligerent and hostile creditors
- Any personal feelings of contempt

Culture, Atmosphere, Institutional Behaviors

- Multiple sub-cultures?
- Meritocracy? Nepotism?
- Fear of consequence?
- Willingness to challenge?
- Does anyone ever laugh?
- Seniority – privilege, tenure, entitlement?
- Concept of Noble Purpose?
- People busy being busy?
- Resistance to change or willingness to embrace?
- Reactive or Proactive?
- Personal Values aligned to Business Values?
- Personal Accountability or willingness to blame?
- Rockefeller self-audit?

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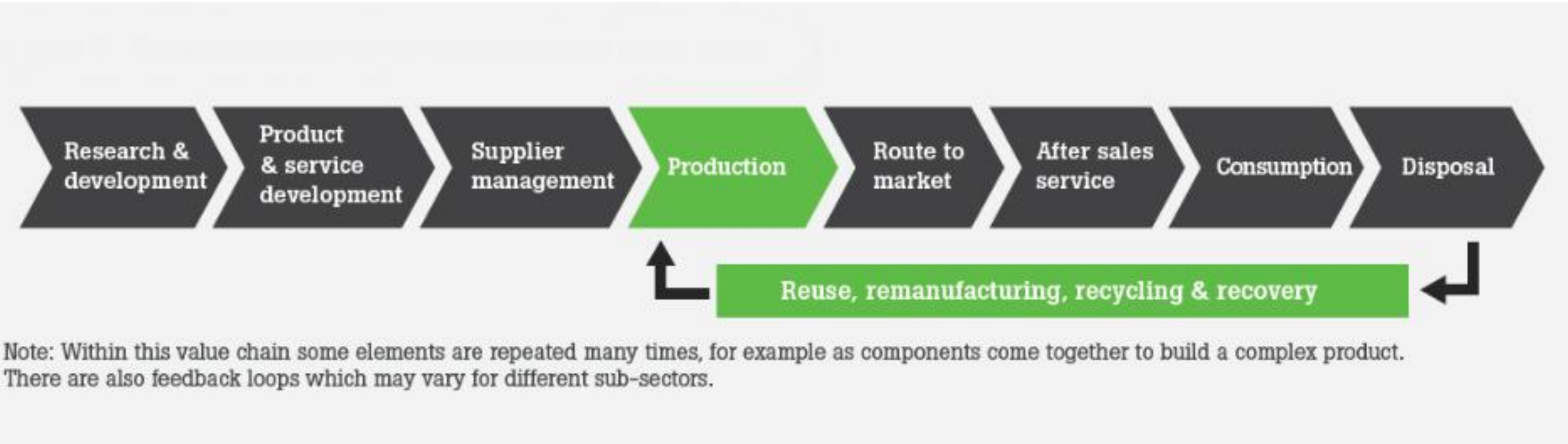

If we walk through the Value Chain of Company X you will agree that certain domains can be considered “non-core”, i.e. they are better managed and will profit from economies of scale as well as core competency focus, within these domains are secondary considerations, such as Marketing, HR, Office Management etc, which will also be considered as part of the Value Chain rationalization and will inform the Company Restructuring discussions.