ARTICLE

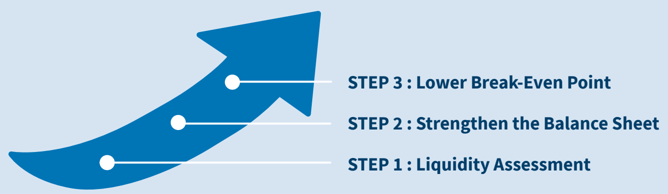
Surviving the liquidity crunch

Stabilise by determining Cash Flow demands, strengthening the Balance Sheet and lowering the break-even point

When the COVID-19 lockdown regulations unexpectedly disrupted 'receipts', whilst leaving 'disbursements' unscathed, business focus rapidly shifted to ensuring healthy operating liquidity.

"Thirty years of crisis management experience has shown FTI that many underestimate the severity of economic shocks and subsequent downturns and end up doing too little, too late."

Business Response Journey



Why the sudden drive for Liquidity and how do we respond?

- The government imposed COVID-19 lockdown regulations impacted the lives of all ordinary South Africans. In the business arena a clear distinction was drawn between 'essential' - and 'non- essential services'.
- For companies operating in the 'essential services' arena the impact was arguably less severe, some companies found themselves in the complex (but less severely impacted) space of a 'quasi - essential services' provider and then lastly the remaining group of companies were faced by the daunting impact of a complete elimination of all revenue generating activities.
- The distressing prospect of the first post lockdown supplier payment run, further exacerbated by the month end payroll and defaulting customers left management with the following questions:
  - *Is there an immediate cash crisis?*
  - *When will a cash injection be needed, and how much cash is required?*
  - *Is the cash crisis the result of fundamental business issues, capital structure issues or both?*
  - *Is this a distressed situation or just a performance improvement scenario?*
  - *Is there a chance that the company may need to file for business rescue or liquidation?*
  - *What areas of the business are the most capital intensive?*
  - *What levers can be pulled to mitigate potential cash shortfalls?*
- It is critical that the 'business response journey' is well planned and coordinated, including the following phases: Liquidity and solvency assessment; Strengthening the balance sheet and Lowering the break-even point.

"A treasury cash flow forecast providing a summary of sources and uses of cash, is essential, whereas the IFRS based cash flow does not provide the granularity required."

STEP 1

Liquidity Assessment

When the economy is operating in positive territory and quarterly cash inflow is exceeding outflows, most successful businesses believe they can weather an economic storm.

But experience shows very few companies have sufficient liquidity built into their normal operating model to survive a quarter where cash inflow is significantly impacted.

The cash flow impact of the current lockdown and the uncertainly related to issues like:

- lockdown duration;
- debtor recoverability,
- inventory valuations and
- changes in customer behaviour,

requires executives to assess whether the business is adequately resourced to weather the short-term liquidity storm and, if not, which available levers can be implemented most efficiently.

Typical Client Concerns

"Do we have an immediate cash crisis?"

"When will a cash injection be needed, and how much cash is required?"

"What levers can be pulled to mitigate potential cash shortfalls?"

"What alternative funding options do we have?"

"Which of our pipeline programmes can we suspend without damaging our future trajectory?"

Typical Activities include the following:

Immediate:

- Prepare weekly rolling cash forecasts. Review the cash trajectory and forecast the weekly closing cash balance. Review the timing of major cash commitments.

- Short-term cash forecasting processes and procedures to improve the visibility of cash requirements.

- Effective short-term cash reporting for internal management and external stakeholders.

- Assessment of liquidity and related cash flow forecasts to understand and analyse the drivers of cash flow.

- Evaluation of whether the business has adequate liquidity to continue operating normally, thereby allowing time for financial stakeholders to consider their options.

- Determine ability to access revolving balance and assess all banking facilities.

- Understand covenants, sweeps and lender remedies. Review vendor terms and accounts payable.

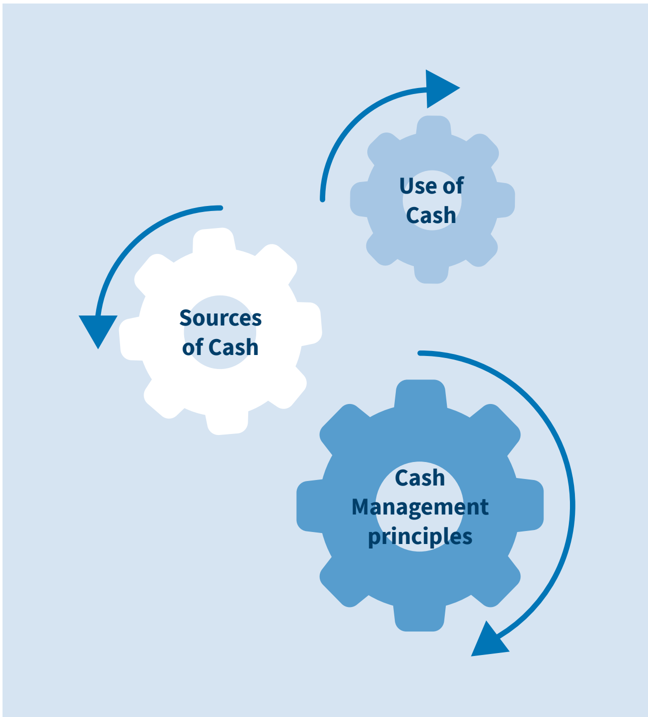
Next 3-6 Months:

- Focus on the major cash events impacting the company. Analyse and understand working capital changes and assess sustainability (some short-term positive impacts might have an unfavourable longer term effect on the business).

- Identify times when funds are likely to be at their tightest and make sure cash is managed accordingly.

- Assessment of the validity of market and strategic assumptions

Business Response Journey



STEP 2

“Balance sheet restructuring can be complex due to the divergent interests of different stakeholder groups and the legal processes required to implement a transaction.”

Strengthening the Balance Sheet

Prolonged periods of deteriorating trading conditions inadvertently leads to cash depletion, weakening of the Balance Sheet and share price decline. Balance Sheet strength directly impacts the number of available levers for survival, whilst it also has a significant bearing on the cost associated with various turnaround initiatives.

Significant deterioration in Balance Sheet ratios typically contained in loan covenants can lead to further liquidity pressures due to defaults allowing creditors to call for immediate payment of principle debt and interest.

Equipping management to successfully steer the company through periods of economic distress requires a robust financial review of the business followed by a detailed options analysis together with scenario planning and appraisal, with the ultimate aim of short term survival, without negatively impacting the long term trajectory and value of the firm.

Typical Client Concerns

“Current and forecast cash generation provides low coverage of interest payments.”

“Currently available and non-ring fenced liquidity is insufficient to cover senior and junior debt payments.”

“Potential future breach of financial covenants given continued deterioration in trading and extensions of cash depletion leading to fall in asset base and solvency issues.”

“Medium term cash generation is largely reliant on capex reduction and working capital inflow.”

Addressing the Concerns

FTI Consulting financial restructuring experts provide comprehensive financial advice to companies, their lenders, shareholders and other stakeholders to support a range of financial requirements and actions including Balance Sheet restructurings, disposal of non-core assets/ operations raising additional capital or refinancing.

Typical Activities includes the following:

- Comprehensive liquidity options analysis and appraisal and evaluation of stakeholder positions.
- Management of negotiations from initial discussions to full documentation of agreed transactions.
- Review of historical and forecast trading performance, including an assessment of the validity of market and strategic assumptions.
- Assessment of debt capacity, financial modelling and scenario analysis.
- Evaluation of whether the business has adequate liquidity to continue operating normally, thereby allowing time for financial stakeholders to consider their options.
- Planning and implementing enforcement and realisation strategies to maximise recoveries, either through light touch/ holding company appointments, or trading under Business Rescue.
- Assessing and developing closure options or exit strategies where a subsidiary, division, product or entire business is to be sold or closed, as well as ongoing management of the implementation of these plans.
- Accelerated M&A solutions for corporates and stakeholders seeking an orderly exit and to avoid the damage to the business that might result from a longer, traditional M&A process. Our teams are able to act quickly to conclude a value maximising transaction in an accelerated time frame.
- Developing and implementing effective and strategic non-consensual financial restructuring plans, either as an alternative to a consensual restructuring deal or to facilitate a restructuring process.
- Using Business Rescue as a tool to restructure onerous liabilities, or to achieve an exit, while preserving and maximising value for the company, its lenders and other stakeholders.
- Using Business Rescue procedures to achieve recoveries in contentious cross border scenarios, where necessary for pursuing investigations, asset tracing/recovery and litigation proceedings.
- Structuring transactions for maximum tax efficiency, including debt-for-equity swaps and pre-pack administrations.

Financial Distress Indicators	Trend
Free Cash Flow	↓
Working Capital	↓
Debt to EBITDA	↑
Debt Headroom	↓
Market Cap	↓
Debt to Assets	↑
Interest Cover	↓
Loans to Value	↑

"A truly successful restructuring solution often requires some form of business re-organisation, including site closures, profit enhancement (primarily through cost reduction opportunities) and the delivery of working capital initiatives to improve cash flow."

STEP 3

Lowering the Break-Even Point

An economic shock followed by a subsequent downturn begs the question whether the current strategy and target operating model is fit for purpose to survive the 'new normal'.

In the quest to survive in an economic downturn, it is important to understand the linkage between cost and value creation.

Faced by a dwindling demand and overcrowded supply, the focus shifts to creating a competitive survival advantage by lowering the break-even point.

Not only does a reduction in the cost reduce liquidity pressure by reducing the immediate cash burn rate, it also creates revenue enhancement opportunities by allowing business to be competitive at price points previously not feasible.

Operational restructuring requires a proper understanding of the 'impactable cost base', segregated into two baselines, namely, the organisational head count analysis and financial baseline.

The organisational head count analysis baseline is impacted by changes in the organisational structure, whilst an impact to the financial baseline is achieved through strategic cost reduction.

Irrespective of which operational restructuring initiative management decides to embark on, it is of paramount importance to have a clear understanding of the potential "size of the prize" together with its associated implementation risk and complexity.

Typical Client Concerns

"Our cash burn rate has increased significantly."

"Our back office support cost is out of kilter with the core / front office cost."

"Cost as a percentage of revenue has recently escalated."

"Can we restructure our support functions to be more effective whilst increasing efficiency?"

"Current and forecast cash generation provides low coverage of interest payments."

"Medium term cash generation is largely reliant on capex reduction and working capital inflow."

"Our production margins are declining against our competitors."

"Does our current business model work if demand remains at the current suppressed levels?"

"We have a significant amount invested in working capital. Can we achieve the same turnover with less working capital investment?"

Addressing the Concerns

An operational improvement plan can deliver significant tangible financial and operational benefits.

The FTI Consulting team of experts develops and implements plans that focus on margin improvement, cash flow initiatives and cost reduction opportunities for companies across a wide range of industries.

Our approach is centred on the identification and delivery of sustainable benefits, and our team helps clients drive operational change within their business.

Typical Activities include the following:

- Business re-organisations.
- Business rationalisation and cost reduction planning and implementation.
- Establishment or enhancement of company finance functions and processes.
- Leadership roles, including CRO appointments, to lead the development, implementation, co-ordination and communication of restructuring plans.
- Evaluation of the management team and structure.
- Reviewing key systems, controls and processes.
- Identifying cash opportunities; for example, identifying and expediting tax refunds.
- Active cash management to identify working capital and other cash flow improvements to maximise available liquidity and minimise any additional cash requirements.
- Treasury policies and procedures, for example, cash pooling and optimisation of global cash and financial covenant compliance reviews.

About FTI Consulting

"We deliver on-demand expertise and execution across the finance organisation, whether to respond to a crisis, establish a stable and efficient organisation, maximise the performance of an existing finance team and systems, or transform finance altogether, by reducing the burden facing today's CFOs so that they can focus on what matters most."

FTI Consulting has offices in Cape Town, Stellenbosch and Johannesburg which are home to our Forensic & Litigation Investigations, Economic & Financial Consulting, Business Transformation, Corporate Finance and Strategic Communications teams.

And with offices in 29 major financial centres across the globe, we successfully serve clients wherever and whenever challenges and opportunities arise.

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