Restructuring in the MENA Region

A Practical Approach

Executive Summary

- The global economic crisis has led many companies to financial distress
- Turnaround programmes can help companies in distress become viable again and unlock value for all stakeholders
- Opportunities to invest in distressed companies suffer obstacles due to the lack of operational expertise and the reticence of debt and equity stakeholders to accept dilutions of their claims
- Implementing turnaround programmes requires systematic and iterative diagnosis, goal setting, planning, actioning and benefits tracking
- The emotional side of turnarounds needs to be effectively managed
- A focus on cash flows and fair valuations is the pillar of effective diagnosis
- Turnarounds require the alignment of all stakeholders through clear communication
- Developed countries do not have homogenous bankruptcy systems and even the United States' Chapter 11 has changed over time
- MENA insolvency regimes are reported to be weak – the weakness stems mainly from unpredictable and slow proceedings
- Better training of bankruptcy court experts and trustees is required in MENA
- *Shari'a* is not irreconcilable with modern insolvency systems
- The culture in MENA needs to change – bankruptcy is a normal process of a free enterprise system

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1. Introduction

Bankruptcy is a normal process of free enterprise

Bankruptcy and the restructuring or liquidation of companies in financial distress is an important part of a free market economy. There is a tension between the social desire to continue distressed businesses and preserve jobs and the exercise of creditor's rights.

Many distressed companies can improve with turnaround programmes

The recent economic crisis has revealed the fundamental weaknesses of many companies that were previously thought to be unassailable. While many of these companies are not viable, others can be viable if proper turnaround/restructuring programmes are implemented.

Stakeholders in turnaround candidates will be interested in this report

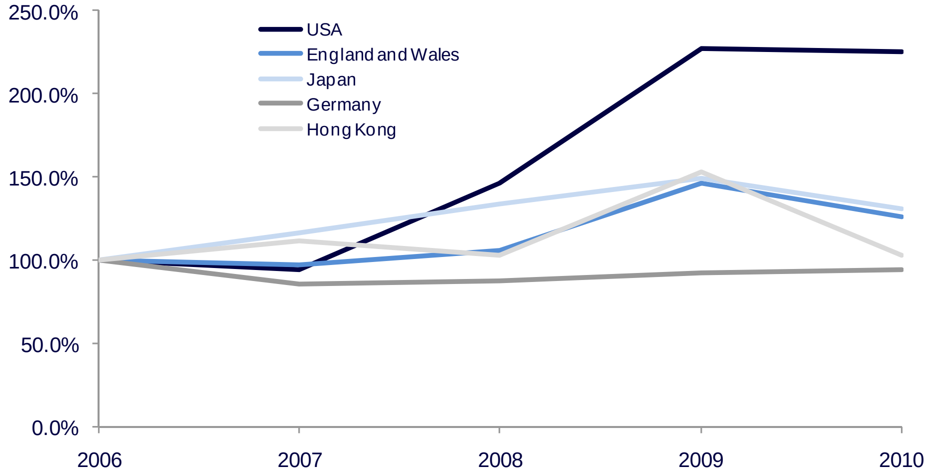
This report is written for stakeholders in companies that may require a turnaround. These stakeholders include shareholders, existing debt providers and potential new investors in a company. The report provides an overview of turnaround transactions and an in-depth look at how turnaround programmes can be implemented. A high-level review of legal frameworks for bankruptcy is included with a focus on MENA.

2. Overview of Turnaround Transactions

The economic crisis has caused financial distress and increased bankruptcies

In the recent global economic crisis, many companies world-wide have found themselves in difficult situations, including financial distress. Paraphrasing the often quoted comment by Warren Buffet, the tide of easy credit went out and revealed the structural fundamental weakness of many corporations. The continued scarcity of credit and reduced investor appetite creates obstacles for enterprises that need to restructure their liabilities or obtain growth capital. It is no surprise that bankruptcies have increased in a number of developed countries, though some signs of stabilisation are presenting themselves (see graph below).

Business Bankruptcies and Equivalents (Index to 2006)



Sources: US Courts, UK Government Statistics, Teikoku Databank, Statistisches Bundesamt Deutschland, Hong Kong Official Receiver's Office, Isthmus Partners Analysis

MENA has also been affected by the global crisis

A survey of insolvency systems in MENA conducted by Hawkamah and other institutions[1] concludes the economic crisis has affected the MENA region: "The global economic downturn of 2008 and 2009, coupled with a steep decline in commodity prices and a global liquidity shortage has meant that an increasing number of businesses find themselves in, or on the cusp of, financial ruin".

Economic crisis evidently creates the need and opportunity for turnaround transactions. However, even in developed countries it is difficult to obtain reliable statistics pertaining to how successful turnaround transactions are. Partly this is due to the complex nature of turnarounds, which make them somewhat difficult to measure except in the broadest sense, and party due to the privacy of such deals. Therefore, in this section we highlight what investors would seek in order to be involved in such transactions and how stakeholders in turnaround targets may react to an investor's requirements.

[1] Hawkamah/World Bank/OECD/INSOL International, "*Study on Insolvency Systems in the Middle East and North Africa*". Available at www.hawkamah.org/events/conferences/conference_2009/files/mena_study_insolvency.pdf

Restructuring capital requires high returns

Investors in turnaround transactions currently require high returns to compensate for the perceived risk they would be assuming. These investors also have enhanced bargaining power in an environment of scarce credit appetite (due to bank retrenchment) and risk aversion from many investors hurt during the economic crisis. Currently those high returns can mean IRRs of high teens to 20%+, in addition to some participation in a potential upside. To achieve such returns, investors would look to either buy distressed debt at a discount and/or inject equity at low valuations. Buying debt at a discount is difficult. Banks have a resistance to sell debt below par, especially if provisions have not been recognised for a particular loan situation. Instead, the "extend and pretend" game is prevalent globally and in the region. If any loans are sold at a discount, it is done behind closed doors, which makes market information very hard to come by. In addition, when the same bank team that originated loans are working out loans, it is difficult to accept mark-to-market loan values. The team is emotionally tied to the loans it made and reticent to recognise losses that would signal to senior management problems they created. A new team is more likely to take a realistic view of fair value.

Buying debt at a discount is difficult to accept

Shareholders can find it difficult to face current valuations of their equity

Buying equity at low valuations can be equally difficult. With high leverage and low enterprise values, very little value can be left for existing shareholders if anything at all. As the value of equity is the difference between the enterprise value and the debt of the firm, many equity holders are looking for time and macro-economic growth to get them out of trouble by increasing the firm's enterprise value. Accepting a low valuation at this point may be less tempting than the option of holding on to see if they can manage the company back to strength.

Buy-in, speed of implementation and project monitoring are key

According to Roland Berger in their restructuring study of 2010, adjustments to business plans were seen as having the greatest impact on dealing with the crisis and new sales initiatives are seen as a major driver to get out of the crisis. Cost reduction programmes and personnel actions were of secondary importance. Of the top three identified restructuring success factors of (i) management commitment, (ii) fast implementation and (iii) intensive project monitoring, Roland Berger reports that the Middle East fell short of the worldwide average.

Corporate restructuring is a common career event of many managers

With the above in mind, many companies will continue to struggle in the short term, as local banks do not have the expertise or manpower to help turnaround businesses. After a prolonged period without economic crisis, many corporate managers are experiencing a downturn for the first time in their careers and are struggling to find a path out of their predicament. Corporate restructuring expert Professor Stuart C. Gilson of Harvard Business School states "corporate restructuring, far from being a rare or episodic event that happens to "someone else", is a common and important event in the professional lives of many managers." Also, only the largest of firms are likely to pay the fees required to hire professionals to help them through any transition period or put together a change management programme.

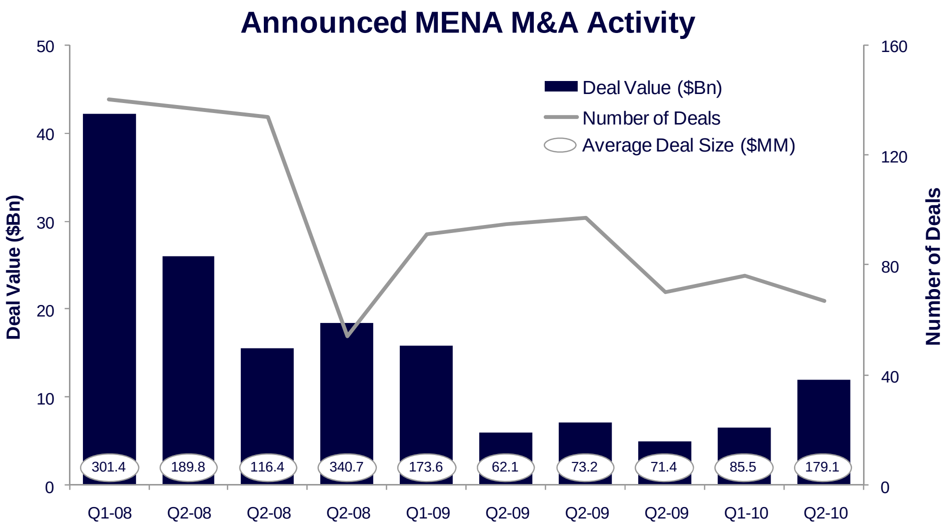
Local investors may have a better understanding and appetite for local opportunities

International institutional funds may be a little sceptical about investment opportunities in the region. Local funds have a better understanding of the market and may see more opportunities. They are less likely to require short-term exits, especially if a going concern continues to produce cash flows. International funds have to benchmark opportunities against other markets where there may be better deal flow, more competitive pricing and a demonstrable track record of exits. In addition, their more stringent corporate governance requirements may alienate managers and owners of potential corporate targets in the region.

Companies that turnaround can gain the upper hand on competition

This translates into few viable turnaround opportunities in the market with numerous funds chasing them. The opportunities that are available may involve companies that are too far down the road of value destruction to save. However, a market where many companies are still finding financing difficult to come by and will continue to do so over the medium term creates opportunities for corporations that manage to obtain restructuring and/or growth capital and that can win market share if the capital is applied prudently with coherent strategies and experienced managers overseeing corporate actions. This will help to turnaround companies and increase value. Both current owners and new investors will then share in the upside of any restructuring and growth.

As acquisitions will provide some insight into the restructuring market, we look at M&A transactions to see the level of corporate activity. According to Ernst & Young, the first half of 2010 saw announced MENA deals fall 15% to $18.5bn from $21.7bn in the first half of 2009. The number of deals is also falling, but it seems larger deals in terms of value are being announced. Q2, 2010 saw $12bn of announced deal value, the highest since Q1, 2009. Below we provide a graph that depicts the change in MENA M&A activity since 2008.



Source: E&Y Update on MENA M&A (Apr-Jun 2010)

There is little information on MENA mid-cap corporate finance activity

Larger transactions and large company corporate actions are widely reported in the media such as Dubai World and Dubai Holding in Dubai, Aldar and Sorouh in Abu Dhabi, KFIC in Kuwait, amongst others. However, the mid-cap market seems to have little activity. This may be due to the difficulty of carrying out due diligence in what are predominantly family-run organisations with relatively poor corporate governance, or with shareholders with unrealistically high valuation expectations, but there are certainly some opportunities for investors and sellers alike, especially if the current owners are kept as part of the going concern. Their understanding of the market and relationships with

Keeping current owners can be a win-win for all parties customers and suppliers will be required not only to ensure continuing operations during any transition phase, but also to help any growth initiatives. This would be particularly true for foreign investors investing into companies within the region.

3. Practical Approach to Restructuring

There is lack of experience with turnarounds in MENA

One major reason for the lack of turnaround deals being completed in the MENA region is the lack of experience and ability to carry out a turnaround programme. Therefore many of the funds raised to invest in the region can be classified as financial capital as opposed to operational capital that may look to improve a company's efficiency or return it to profitability. Strategic buyers looking to buy market share or diversify within their industry are the more likely buyers of companies that can be improved.

In this section we look at how companies can be restructured to deliver greater performance. Challenges present themselves in turnaround programmes, not least the amount of sheer hard work that is required in resolving issues and aligning the various stakeholders both within a company and financial participants. The region's developing legal frameworks can also be a limiting factor and we cover that topic in the next section.

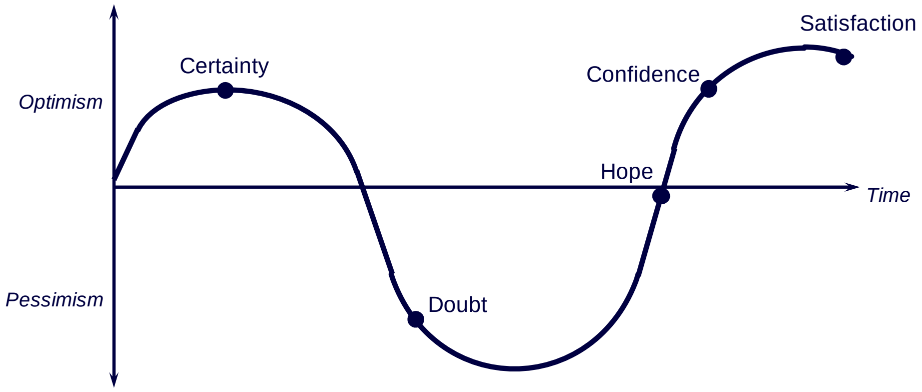
The Emotional Side of Turnarounds

The emotional side of corporate restructurings should not be underestimated

Before looking at the steps that can be taken to assess and restructure poorly performing companies, it is important to note that turnaround programmes are not purely about business logic. There is a formidable emotional side to change. First, current shareholders need to understand and accept that there is a need for change. In a region where business failures carry a greater stigma than in countries like USA, this is hard to accept. Also, shareholders are more likely to attempt to resolve issues on their own without taking advice from external consultants that may have greater experience in change management processes and turnaround diagnostics. Partly this is due to people overestimating their ability to run companies as they become larger or as they face downturn situations, partly this is due to reluctance to pay fees for advisory services, and partly this is due to not knowing whom to trust with such an important task.

Second, change in itself can be a distressing process, where all stakeholders from employees to customers to financial participants can feel uneasy and uncertain. That is natural, as there is no guarantee of success and the outcomes, however well planned, can be different from forecasted scenarios. Although participants may profess to use business logic and market knowledge in their decision making processes, the emotional side of the equation cannot be ignored, as it can frame how people respond to data and progress reports.

Emotional Cycle of Change



Source: Gemini Consulting, based upon "The Emotional Cycle of Change",1979, Don Kelley and Daryl Conner

Managing emotions is part of the project management process

The graph above depicts the emotional rollercoaster that befalls many people through an organisational restructuring. Initially, as the programme starts there is a wave of optimism due to putting plans in place and buying into the forecasts that can be achieved. Action plans and aligning streams of workers to carry out tasks to turnaround a business can have a galvanising effect. However, soon after starting work certainty can quickly turn into uncertainty, as the amount of work required and its difficulty dawns on all those involved. As work continues, doubt that the company can be changed surface and optimism turns into pessimism. It is important at this stage to rely on the change process and the experience of those who have carried out such programmes before. Programme stage gates should be in place to guide decision makers and measurable and realisable deliverables and milestones should be evaluated rationally. When decision makers' personal objectives and prosperity relies on the success of a turnaround programme, the low points of the emotional curve can serve as powerful agents to act irrationally. In addition, this is the period in which stress in many stakeholders can increase and make working life uncomfortable, which supports the need for a strong and experienced project manager.

A successful outcome creates great satisfaction

As quick wins are achieved and latter milestones are reached, the tide will turn. Stakeholders will see results and participants will start to become more optimistic. Gains in efficiency will bring back hope in the programme that will turn into confidence in the decisions made and the ultimate success of the programme. Finally, as the turnaround programme comes to an end and the organisational structure is changed to reflect the desired operational model, all stakeholders will feel a satisfaction that stems from a now more efficiently run and cash generative business.

Long programmes will have mini-cycles within them

The above cycle can also occur in mini-cycles throughout the turnaround programme. Larger programmes that last more than six months are likely to have several phases that will run through their own emotional cycles. Streams within a phase may run through cycles independently, which poses issues when streams work at different speeds or have timeframes that are not aligned. A good project manager will ensure that these various cycles are managed well, but also realise the risks they pose to a programme.

Turnaround Process

Turnarounds focus on cash

With the above in mind we now look at how turnaround programmes can take affect. In essence, turnarounds are about looking at how cash is used within a business to cut unnecessary leaks and finding the core of a business to understand better ways of growing it. On the face of it this may seem simplistic, but it is in the implementation that we find our most challenging tasks.

All stakeholders need to show commitment to the process

Before embarking on the turnaround process, there must be a willingness to carry out a turnaround programme. The myriad of stakeholders will need to show commitment to various tasks and changes. Financial stakeholders may need to dilute their interest in the firm's enterprise value. Lenders may need to reduce loan amounts and extend maturities; shareholders may need to see other stakeholders take equity in the company. If a business is likely to return to producing strong financial performances, this initial dilution may be rewarded with realised value in the future. However, if a business is facing serious distress, financial stakeholders need to look at how much they can recover from a going concern versus liquidation whilst considering their legal rights.

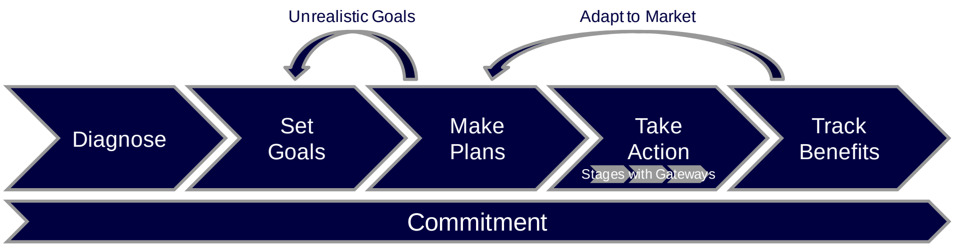
Tough decisions on business strategy and staffing may be required

Management will need to make tough choices on staff and the company's business strategy. Taking a hard look at the market in which the company operates may require companies to change their business strategy, which can either be overambitious, or inappropriately applied. In addition, some form of operational, IT and/or process modernisation may need to take place.

The turnaround is a systematic and iterative process

Once the various stakeholders have agreed to change, a systematic process should be followed to carry out the programme. The diagram below depicts the change management process from diagnosing issues to tracking benefits of changes put in place. The process has a certain degree of iteration within it. Feedback loops will help to fine tune the changes that need to be made, and once the programme has come to its conclusion the company should still seek to continuously improve its efficiency, albeit in a more modest manner, through the tactics employed in the turnaround programme.

Turnaround Programme



Source: Isthmus Partners

<u>Diagnose</u>

Diagnosis starts with focus on revenue lines

The initial step is to diagnose the issues the company faces. This can be done in many ways; however, a financially focused process will provide the best route to most issues. In the **first stage** we look at the cash generation ability of a company. A number of revenue line questions must be investigated including:

- What are the main revenue lines for the business?
- Will all current revenue lines remain?
- Is their any concentration in customers, geography, products and services, etc?
- Is there any seasonality or "lumpiness" within the revenues?

From this we can see how much cash is coming into a company. Analysis will show the robustness of each revenue line and if there are any risks that need to be monitored. Local market experience can help the due diligence process through conversations with market participants including suppliers and customers.

Understand costs to plug leaks and remove inefficiencies

The **second stage** is to understand the uses of cash within a business. A direct cash flow statement is the best place to start. From this we can see all the drivers of cash outflows. If a company has various lines of business, we may wish to break down the cash flow statement further by those lines. The overheads do not need to be allocated, as we can use a contribution model to understand how cash positive each line of business is later in the process.

We need to understand the largest cash outflows to see if we can reduce them, and also identify any cash leaks that can be plugged through restructuring or suspension. Essentially, the business will have to start justifying all cash outflows and each line of business will have to justify its existence.

Understand the balance sheet – what is the true picture

The **third stage** is to take a hard look at the balance sheet and produce a fair value version. The objective here is to understand the true financial situation of the company. Valuation to a certain degree is subjective, but to miss out this step or to optimistically understate liabilities and overstate assets will only undermine the whole turnaround programme, which may point to a lack of will to really fix the problems a company faces.

There are various pieces to the asset side of the balance sheet, some of which require special attention. The Accounts Receivable (A/R) can be a problematic asset. As credit is hard to come by and liquidity is low, customers have been slow to pay, or have stopped paying altogether. Some customers promise to pay through rolling up A/R with new and larger contracts increasing risk. It is likely the company is holding A/R that is unlikely to be paid and this should be reflected in the fair value of this asset. We would encourage a deeper look at A/R, not just looking at an aged report that can hide certain details such as customer concentrations, varying payment terms, etc.

Identify core and non-core assets

Companies need to understand their core and non core assets. For some assets this is straightforward. For instance, factory and plant to produce a company's product can be considered core if we disregard outsourcing solutions for now. Unrelated real estate assets or minority investments in third parties can be classified as non-core. Core assets are intrinsic to a company and the cash generative ability of a company is directly tied to those assets; therefore they should be considered separately. They will be held to maturity and a company needs to understand how long it can utilise them. Non-core assets need to be valued as if they will be sold at market prices.

Realistic valuation of assets will underpin how a company can move forward

Inventory should be valued at market prices as if it was sold within the short term. Some inventory may be obsolete, so forced sale prices should be used or the inventory should have no value attributed to it. Some inventory may be in various stages of production, which can add complexity to the process.

A company may also hold assets that are loans provided to others; oftentimes to related companies. These loans should be treated as if they were made at arms length, which means recognising the likelihood that they will be paid. Goodwill should be realistically assessed and other assets, such as prepaid expenses, are of secondary importance and can be marked at book value if their size compared to total assets is not overly large. If other assets are sizable, further analysis may have to be performed to better understand them.

Liabilities are assumed to be met

Officers and directors may need to seek legal advice if a company falls into negative equity

The equity and liabilities side of the balance sheet is easier to manage. The company should assume it needs to pay all of its liabilities as stated, at least until there is a turnaround programme in place. Concentration and types of liabilities should be analysed. If a realistic balance sheet analysis indicates negative equity (third party liabilities > assets), officers and directors of the company may need to consider their legal situation and avoid falling into criminal offences such as bankruptcy by negligence. If the turnaround programme is clearly being implemented for the benefit of all stakeholders in a consensual manner this might not be an issue, but expert legal counsel should be sought and assurances provided to officers and directors.

Tie the financial analysis together through a sources and uses table

In the **fourth stage**, the company needs to tie the study of sources and uses of cash together with the balance sheet analysis. The quality of revenues will look to tie the top line of the direct cash flow statement with the Accounts Receivable. It will also provide a view on the concentration of customers and business lines. The cash outflows will indicate the cost of maintaining certain assets and servicing liabilities.

Understand working capital and cash cycle

In the **fifth stage**, the company needs to understand its working capital position, the cash generation cycle and any under-funded positions related to current operations. Managing working capital better can help generate internal cash that could be regarded as a quick win within the overall turnaround programme.

Estimate realistic reinvestment requirements

Finally, in the **sixth stage**, the company needs to understand its big cash reinvestment outflows in the future on Property, Plant and Equipment (PP&E). This will provide a view of how much capital will be needed in the future to ensure the company does not have a potential liquidity problem.

Workshops help reveal inefficiencies

The financial analysis described here should be augmented with workshops with employees to understand the operations and processes, and interviews with key managers to understand how a company's strategy is defined and ultimately executed. Workshops are time consuming and most valuable when people from different departments are involved especially if this reveals contradictory views. People see tasks in different ways and believe in various reasons for inefficiencies. When bringing disparate groups from within an organisation together, it is sometimes easier to discover those inefficiencies. A well planned out workshop will help discover the applied rather than supposed processes within a company and ensure that all voices are heard, but an experienced facilitator may be required to elucidate all viewpoints.

Set Goals

Develop a financial model to measure the effectiveness of proposed changes

With all the above analysis complete, a company would then be in a position to better understand what needs to be done to ensure the company's viability. The information thus collated will enable a company to develop a financial model to understand how it can achieve its objectives, whether that is deleveraging, increasing sales margins, etc. The financial model will help a company develop scenarios designed to achieve these objectives and value each approach, as well as provide an aid to risk management.

Investors will analyse feasibility of an investment

Turnaround specialists and other investors will likely go through the above process when evaluating an investment into a business. Scenarios such as the type of investment made (buying debt and/or injecting new capital through convertible debt, equity or preferred shares) and likely exit will help investors assess the feasibility of any investment.

Goals expressed through KPIs need not only be financial

The goals that are set need to be specific, identifiable and measurable. However, not all goals will be financial. Key Performance Indicators (KPIs) should reflect all key areas of the business from staff retention and training to factory throughput efficiency to the bottom line. Where possible, KPIs should be compared to market averages and best in class. In the MENA region, lack of data may make this difficult especially considering the private nature of the majority of companies. Developed country KPI benchmarks may provide some insight and at least give some indicative benchmark levels.

Awareness of opportunity costs is important

Investors will use their analysis of a company as a baseline from which to commence negotiations on distressed debt sales or buying equity at a discount. Company owners and creditors need to understand their best alternative to an investor's proposal if they are going to negotiate a realistic deal. Creditors and shareholders cannot simply bury their heads in the sand and hope the problem will go away or play a purely waiting game. Opportunity costs are high and the company could become further distressed.

Make Plans

Translate goals into plans taking constraints into account

Once goals are set, a company needs to identify ways in which to achieve them. During the planning exercise, it is important to note that time or business constraints may appear that will hinder achieving the goals that have been set. Therefore, there is an element of iteration between goal setting and plan making. Potential investors will look at this stage as the deep due diligence period required to really understand if there is value within a company before committing funds and trusting the company's management and external consultants to deliver. The financial model should reflect any changes in the goals and programme timing, which will also include the cost of the turnaround programme of which the highest costs will likely be the company's employees and professional fees.

Identify key people who will implement plan

This phase includes a number of stages. To commence, a company needs to identify the people within the company that will carry out the implementation. Those people should be involved in the planning process. On occasion, a company may need to hire external consultants who are experienced in turnaround programmes that can help implement a turnaround.

Identify deliverables that can be measured against plan

Plans should include identifiable and measurable deliverables that are linked to certain goals. Some goals may have to be achieved through several phases, but milestones will need to be identified to ensure the programme is on target. Several streams of work may be kicked off to ensure the whole programme progresses well and these streams need to be co-ordinated. Programme plans should be available not only to all the people involved in the implementation plan and management, but also generally to all employees. Involvement and communication will help all the company stakeholders to aid the success of the programme.

Take Action

Take action through a systematic process that has multiple check points

Once plans are in place, implementation will follow. Stage gates will be used to monitor the progress of the turnaround programme. For stage gates to be effective, any steering group will need good progress reports. Milestones and deliverables will be identifiable and measurable and linked to a programme's goals.

The steering committee will have a key coordinating role – it should have "teeth"

The steering committee should have some real decisions to make on the programme. It is not just a box ticking exercise. If the programme is not achieving its stated goals, the committee should have the authority to make changes to the management, the set goals or, in extreme cases, to terminate a programme. If investors have to inject further capital at stage gates, the amount spent to date should be seen as sunk capital and any "go, no-go" decisions should be made on new IRR projections from that point. Investors will have positions on the steering committee and will yield a fair amount of decision making power on that body especially if they are there to provide further capital injections.

Project managers should provide regular updates to steering committee members, not just at stage gates, which can be months apart. These progress updates should provide information about progress against timelines and budgets broken down by work streams, a description of work carried out to date and a risks and issues log.

Track Benefits

Track progress of actions to ensure the benefits are achieved

Many companies believe that once improvements are made that the turnaround programme is complete. Far from it. At this point, companies need to put into place benefits tracking processes that enhance regular accounting mechanisms to understand if the improvements that have been made are taking hold for the long term and how much value is being derived from those improvements.

Don't let situations deteriorate again without taking remedial action

Tracking also provides an early warning system for companies that relapse into inefficiency or as market conditions adversely affect the cash generation ability of a business. Through continual monitoring, companies can take quarterly views on how to persistently drive productivity up and adapt to market forces. Tracking can pinpoint areas for improvement, whereby management can put new plans into place for further improvements.

Alignment

Throughout the turnaround programme, alignment of the various stakeholders needs to be considered. This will help to ensure that any changes made are not only better understood, but are also long-lived.

Stakeholder alignment is bottom up and top down

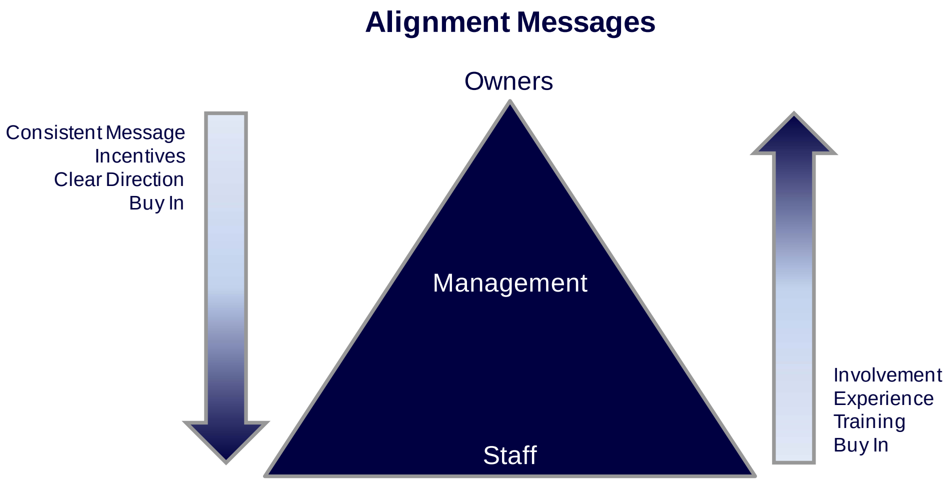
The alignment of stakeholders can be carried out in a number of ways; both bottom up and top down. Bottom up approaches would require a number of empowerment tools and processes that would allow grass roots level staff to be part of the process and to somehow share in the overall success of a firm. In MENA, this type alignment is less prevalent for a number of reasons. First, culturally the region is relatively more control process oriented, which leads to a staff that predominantly follows protocols setup through a hierarchical structure. This can be amended, but managers are likely to resist such changes and relate them to poor governance especially if there is minimal trust between staff and managers. Second, staff that is accustomed to following direction would need to be retrained to cope with more dynamic situations. Third, certain roles with an expanded scope of duties would require better educated or more senior staff than those on hand, which would mean a greater cost per head though overall personnel costs may fall. This is difficult to implement in the region where there is proclivity to cheaper staff in greater numbers. Finally, it is not customary to allow grass roots level staff to share in any benefits that arise out of greater operational efficiency.

Information flows can be slowed through management layers

Alignment through top down directives is much more prevalent within the region. Control processes are put in place and information flows usually pass through several layers of management before decisions are made. This creates inefficiencies as information flows are slower and more cumbersome and both the message and its intent can be altered as information passes from one layer of management to another. Also, ultimate decision makers can be owners, who have little day to day interaction with a firm's operations.

Use management consulting tools for implementation

To avoid some of the identified problems, we need to understand that change management programmes are projects and not part of an individual's line role. Staff may play a part on the project and simultaneously keep some of their line role duties, but some time will need to be devoted to the project in exclusivity. In addition, certain tools can be used to help the project team to understand key objectives, the role each stream of work plays in the overall plan, interdependencies, and how each person on the programme is expected to participate. Such tools would include transformation maps, Gantt charts, milestone and deliverable plans, roles and responsibility charts, etc. Ideally these tools would be highly visible, and project teams will continually refer to them. In that way, project participants can keep abreast of progress and all other stakeholders can understand the timeframe of change and how and when they as individuals will be affected. For an overview of such management consulting tools, please review section five of Isthmus Partners' January 2010 report: Venture Capital: A Pragmatic Approach (available at www.isthmuspartners.ae and the Publications tab).



Source: Isthmus Partners

Owners / managers need to take charge of the alignment process

Ensuring alignment is a complex objective that requires the message from owners and management to be consistent and plain, whilst continual buy-in is sought from employees. From a top down perspective, it would be preferable to have a visible owner or manager that owns the process and that can be seen as driving it forward. Other owners and managers need to be behind the programme also, and support again must be visible. This can be achieved in a number of ways, but most would involve some form of communication that pervades the rest of the organisation, such as e-mails, newsletters, presentations, the Internet, or a combination of media.

The messages need to show clear direction, and provide pointers to how well the programme is achieving its desired objectives and refer to progress against plan. Financial metrics do not have to be revealed, especially for a private company, but other Key Performance Indicators (KPIs) can be involved, especially if those KPIs will be used to measure the performance of a division or individual employee. Any changes to plans should be relayed with reasons, so the organisation can understand which amendments are being made, how they affect individuals and why they are being made. Over time, people appreciate "being in the loop", even if the short term pain of a change programme is difficult. The alternative of no or little communication fosters rumours which can lead to false conclusions and higher staff turnover especially among the more highly mobile and valued employees.

Remuneration is not the only compensation for employees

From a bottom up perspective, we have to understand that the control structures in place in the region are not going to change overnight. Therefore we need to work with them, but also become more engaging with employees, to whom we can demonstrate the importance of their buy-in and how they can benefit. Remuneration benefits are important, but there is a body of academic research that shows other benefits provide longer term advantages to an organisation. Soft benefits help to reduce employee churn and make for more motivated staff. Much of this is based on engaging people, and ensuring they are properly trained and have growth opportunities. This is a win-win situation where the organisation would benefit not only from having more engaged employees, but also from using their experience on the "shop front".

To achieve such a balance, any change programme needs to run workshops with employees to discover how any as-is process is deficient and what changes need to be put in place to make a company more productive. Also, by understanding each process better, a change team will be able to determine where interdependencies lie, if there are any bottlenecks or underutilised resources in the organisation’s operating model, and whether human resources need to be changed, trained, or reduced.

Involvement creates buy-in on its own, but the process will also highlight employees that need to be rewarded for superior performance and those that need further training.

4. Overview of Legal Restructuring Frameworks – Focus on MENA

Global Overview

Conventional wisdom with respect to bankruptcy in MENA is too simplistic

Conventional wisdom states that developed countries have enlightened legal frameworks with respect to bankruptcy and creditor rights that allow viable distressed companies to continue as going concerns while liquidating non-viable companies, and are therefore economically efficient. The same conventional wisdom contrasts developed countries to MENA, where the legal frameworks are not as enlightened and the influence of *Shari'a*, because it is not "modern", leads to "non-efficient" economic outcomes. A review of specialist literature shows that the background to legal restructuring is not as simple as conventional wisdom dictates.

Developed countries have two distinct bankruptcy systems: Reorganisation and Auction

First, developed countries are not a homogenous block with respect to bankruptcy laws. Hotchkiss et al (2008) in their paper on "Bankruptcy and the Resolution of Financial Distress"[2] provide an overview of bankruptcy laws that "vary considerably across the world". Two distinct systems stand out:

- Reorganisation code: "Provides strong provisions for a court-supervised renegotiation of the firm's capital structure. Creditors have limited influence over the bankrupt firm and incumbent management is typically allowed to continue to run the operations". Chapter 11 of the US Bankruptcy code is the standard bearer of a reorganisation code.
- Auction code: "Mandates a public sale of the bankrupt firm's assets. The bidder offering the highest price decides whether the firm is liquidated piecemeal or survives as a going concern". Sweden is a good example of an auction code.

There are differences in how creditors are treated within reorganisation systems

Within countries that use reorganisation codes there are strong differences in the principles and applications of legal frameworks. Hotchkiss et al state that the French code's objectives are, "in order of priority, to continue the firm's operations, to maintain employment, and last to pay back creditors". Debtholders are restricted from participating in the restructuring process, being represented by a court-appointed officer while employees appoint their own representative.

The Chapter 11 process has suffered changes over time

The application of Chapter 11 has not been homogenous over time. Some academic literature criticizes Chapter 11 for being too lenient on debtors and there is evidence that companies emerging from Chapter 11 tend to remain economically inefficient. Academic literature also supports that the practical application of Chapter 11 has changed since it was introduced in 1978, with more creditor control progressively being exercised over time. In addition, the Bankruptcy Reform Act of 2005 enhanced the rights of creditors by limiting the management exclusivity period to propose a reorganisation plan and the extension of the

[2] Hotchkiss, Edith S., John, Kose, Thorburn, Karin S., Mooradian, Robert M., *Bankruptcy and the Resolution of Financial Distress* (January 2008). Available at SSRN: http://ssrn.com/abstract=1086942

fraudulent conveyance look-back period (“claw-back”).

Potential outcomes for financial distress include out-of-court restructurings, pre-packs and straight court filings

There are three potential outcome of firms in distress:

- Out-of-court restructurings.
- Pre-packaged bankruptcies, where the borrower and main creditors agree to a reorganisation plan which is filed with the bankruptcy application. “Pre-packs” have tax advantages and overcome holdouts like a bankruptcy filing, while avoiding long and costly bankruptcy proceedings.
- Straight application for bankruptcy.

Academic literature suggests the more distressed and complex a debtor’s situation, the more likely the debtor will have to file for a non pre-consensus bankruptcy, which has the highest direct and indirect costs of bankruptcy and the least likelihood of ultimate success.

Key features of Chapter 11 include APR, cram downs, DIP, automatic stays and committees

Key features of Chapter 11 are:

- Absolute priority rule: senior creditors obtain repayment ahead of junior creditors, and secured creditors ahead of unsecured creditors. Within the same class of creditors there is pari passu (equal) distribution. In practice, oftentimes junior creditors obtain some form of compensation from senior creditors (even if the senior creditors are not paid 100%) in order to expedite the process.
- Cram down: bankruptcy courts can impose reorganisation plans on dissenting classes of creditors (or “holdouts”) if under the reorganisation plans the holdouts received more than a straight liquidation of the firm. Cram down is rarely enforced; rather the threat of cram down is imposed.
- Debtor-in-possession (“DIP”) financing: a debtor can obtain DIP financing for business expenses. DIP financing is granted a super-senior status; therefore there are financiers willing to extend DIP financing. This is very important as it provides the debtor liquidity to survive during the reorganisation process.
- Automatic stay. Payment of all interest and principal to creditors ceases and secured creditors cannot enforce their collateral.
- Committees are appointed to represent different classes of claimholders before the court.

Chapter 11 is about non-coercive bargaining; however many times the court needs to supervise processes

Chapter 11 encourages bargaining among claimholders with limited court intervention. However, as per Hotchkiss et al: “In a perfect world, claimholders of a financially distressed firm would always renegotiate and voluntarily agree to a restructuring.......however, with impediments such as information asymmetries, holdout problems and conflicting interests, firms sometimes resort to bankruptcy for a court-supervised reorganisation”.

Middle East & North Africa

MENA insolvency regimes are rated as weak with respect to effectiveness

With respect to the MENA region, the IFC/World Bank report on 'Doing Business in the Arab World 2010'[3] states that MENA "with its divergent economies, generally ranks amongst the weakest regions when it comes to the effectiveness of insolvency regimes. Recovery rates are often less than 30 cents on the dollar". Structural weaknesses in MENA identified include:

- "Courts that are unable to handle cases swiftly and predictably;
- A predisposition by lenders to attempt swift, piecemeal liquidation rather than work through a difficult turnaround; and
- Inadequate legislation that leads disproportionately to business failure rather than rescue".

Family run businesses are less likely to want to go through bankruptcy as they may lose control

In addition the IFC/World Bank highlights some unique factors: "The region has some of the largest family owned businesses in the world and a disproportionate number of privately held businesses. Such companies are unlikely to want to undergo a formal bankruptcy process, which, under most bankruptcy laws in the region, would result in a loss of control of the business".

Hawkamah and other institutions in their survey on MENA insolvency regimes point to two main deficiencies:

- "First, the systems do not provide appropriate incentives for debtors, creditors and trustees to enter the insolvency process, conduct it in a cost-effective way, or to reorganize potentially viable firms and avoid their premature liquidation;
- Second, the insolvency systems are not effectively enforced".

The survey highlights excessive punishment of honest debtors, the non-observation of the absolute priority rule, perverse incentives for bankruptcy trustees and gaming of the insolvency system by creditors in a "race to seize assets".

The implementation of insolvency regimes is the Achilles' heel of MENA

The application of insolvency laws by courts and trustees are the main obstacle to effective application of insolvency regimes in MENA. As summarized by IFC/World Bank, "Governments can help by encouraging firms to seek pre-insolvency solutions, improving the efficiency of courts and training receivers and liquidators to do a good job in administering distressed companies and selling their assets efficiently".

The bankruptcy provisions the UAE seems to have much of the features of developed countries

The law firm Ashurst in its publication 'Bankruptcy, insolvency and restructuring in the UAE'[4] looks closely at the insolvency regime in the United Arab Emirates. This insolvency regime includes instruments such as:

- Protective composition: a debtor can propose to the court an arrangement that must provide for at least 50% repayment of debt

[3] World Bank and the International Financial Corporation, *Doing Business in the Arab World 2010*. Available at http://www.doingbusiness.org/reports/special-reports/arab-world-2010/

[4] Ashurst United Arab Emirates, *Bankruptcy, insolvency, and restructuring in the UAE* (April 2009). Available at http://www.ashurst.com/doc.aspx?id_Content=4386

within three years. This avoids declaration of bankruptcy. Upon filing for protective composition there is an automatic stay on creditor actions.

- Judicial composition: an arrangement proposed following a declaration of bankruptcy and that if approved can annul the bankruptcy.
- Cram down of minority creditors if relevant threshold of creditors approve protective or judicial composition.
- Claw back of certain transactions for up to two years before the declaration of bankruptcy.

The UAE's insolvency regime does not contemplate DIP financing and the absolute priority rule is unclear and untested.

It's the application in the courts that leads to uncertainty

However, Ashurst states that "...there has been a reluctance on the part of participants to use formal insolvency procedures in the UAE.....they would appear to stem from a lack of understanding of the procedures, uncertainty as to how the UAE insolvency regime would be applied by the courts...and finally what appears to a cultural aversion to such formal procedures".

Expertise and predictability in courts and trustees is required

In summary, it is not enough to draft legislation for change to happen. An issue as complex as bankruptcy requires expert courts and trustees that will supervise fair and predictable processes. With more experience and certainty of court solutions, out-of-court solutions may also be handled in a more efficient manner and participants will be discouraged from gaming the system or pre-empting the game-playing of other participants.

Shari'a Law

In many majority Muslim countries, *Shari'a* law is either a source or primary source of legislation.

Awad and Michael (2011) provide a review of classical Islamic law and bankruptcy[5]. The authors consider five primary concepts that constitute the foundation of Islamic law of bankruptcy:

- Prohibition of *riba* (interest);
- Obligation to be socially responsible;
- Divine directive to pay all of one's debts;
- The absence of limited liability or entity shielding concept; and
- The absence of concepts of intangible assets and many forms of non-possessory rights.

Shari'a principles balance social responsibility with obligation to repay debt

The authors cite the Quran, at verse 2:280 as the primary textual authority for the Islamic law of bankruptcy: "If a person is in difficulties, let there be respite until a time of ease. And if you give freely it would be better for you, if only you knew." These principles of social responsibility and charity are balanced by the Quranic verse that compels Muslims to repay one's debts: "o you who believe, you shall fulfil your covenants". Just like in

[5] Awad, Abed, Michael, Robert E., *Iflas and Chapter 11; Classical Islamic Law and Modern Bankruptcy*. The International Lawyer. Published in cooperation with SMU Dedman School of Law. Available at http://law.pace.edu/files/Awad-and-Michael_2011_International_Lawyer.pdf

non-Islamic frameworks, there is a tension between the obligation to fulfil contracts and the social reality of bankruptcy and public policy.

Shari'a is not irreconcilable with modern bankruptcy systems

Awad and Michael summarize in their review "that the treatment of a *muflis* (bankrupt) under classical Islamic law is strongly analogous to the traditional civil and common law treatment of bankrupts prior to the enactment of Chapter 11 of the US Bankruptcy Code in 1978. Prior to Chapter 11, bankruptcy laws had as their primary, if not sole, function a fair and equitable distribution of the debtor's assets among his or her creditors. The revolutionary change of Chapter 11 was to make the paramount purpose of the insolvency proceeding the rehabilitation of the business enterprise. As non-Islamic law used the mechanism of the discharge to avoid punishing debtors and letting them lead a debt-free life, the *Shari'a* kept the debt from increasing over time while imposing moral suasion to reach settlements and forgive unsustainable debts. To develop a *Shari'a* compliant version of Chapter 11, Muslim nationals must first accept.....that the economic continuation and revival of ongoing business enterprise is more important, as a public policy matter, than the maximum short term satisfaction of the business's debts".

Culture

Culture also matters – a lot!

There is an aversion to lose face and a culture of blame

As detailed above, *Shari'a* principles are not impossible to reconcile with modern bankruptcy frameworks. What may be more difficult to reconcile is the culture of the region. In Southern Europe and much of Asia there is culture of shame associated to bankruptcy, and a similar strong aversion to recognise bankruptcy and failure exists in MENA. And when failure is recognised, there is also a culture of blame – someone has to be 'responsible' for the events that have happened. As Hawkamah and other institutions highlight in their survey of MENA insolvency regimes, "MENA insolvency systems do not motivate honest debtors who have failed due to no fault of their own, to make a fresh start or prepare a sensible reorganisation plan".

A symptom of the blame culture is the custom in some jurisdictions to take post-dated cheques as instruments evidencing financial debt, and that trigger criminal offences and imprisonment upon non-payment.

Combining a culture of aversion of recognising faults and the fact that most businesses are family owned, it is understandable there are challenges when facing difficult situations and engaging in turnaround programmes. This is especially true when many of those businesses not only support members of an extended family, but also provide a point of identification and legacy for certain family members.

5. Conclusions

Companies globally are being forced to deleverage, which should provide some investment opportunities in the distressed market

The world is going through some painful times at the moment, where companies need to deleverage and concentrate on increasing revenues and productivity. A number of investors are looking to capitalise on this process by investing in debt and/or equity, but few deals are struck as managers and owners attempt to steer their companies out of financial issues through their own growth and greater macroeconomic stability. Some of those companies will succeed, but others will fail due to inexperienced management, lack of real revenue drivers, inefficiencies, debt and equity holders inability to agree on write downs, etc. In addition, the opaqueness of the distressed market does not help companies understand the options available to them.

Turnarounds should have a focus on cash flows and growing the core business

We provide an overview of how the turnaround process can be applied at a company level, tied to a restructuring of liabilities and/or bringing in new investment funds. Turnaround programmes are complex and lengthy, requiring project management discipline and buy-in from all stakeholders to implement successfully. A focus on the core business to grow revenues and a direct look at cash outflows to understand and plug cash leaks should provide a link to realisable goals that leads to a successful turnaround.

Fewer stakeholders and an awareness of opportunity costs can facilitate turnaround processes

We recognise that turnaround/change programmes with liability restructuring outside of formal bankruptcy routes will require situations where there are relatively few key stakeholders (large shareholders and debt concentrated in few hands such as a bank loan from the "house" bank) so interests can be aligned and that there is an awareness of opportunity costs.

Developed countries have heterogeneous bankruptcy frameworks – there is no ideal model

Finally, we provide an overview of bankruptcy frameworks. Developed countries have varying frameworks and systems of implementing those frameworks, and each country's systems evolve over time. Bankruptcy is a very complex process that requires expert courts and bankruptcy practitioners to implement and provide the motivation to participants to reach reasonable consensual decisions and try not to game the systems.

In MENA culture and implementation are key obstacles to efficient insolvency systems

Shari'a law can be reconciled to modern bankruptcy systems. What is more difficult to reconcile is culture and implementation. International institutions highlight the need in MENA for expert courts and practitioners that would expedite bankruptcy proceedings and provide predictable outcomes to participants.

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Isthmus Partners is a UAE based boutique that offers consultancy advice in the corporate mid-cap and real estate. It was founded and is owned by three partners with a wealth of principal finance and consulting experience from 25+ years in investment banking and management consulting. In the mid-cap sector, Isthmus Partners advises its client's management on business development, restructuring and growth. The partners have worked on a number of new venture proposals based on product and materials manufacturing across the GCC, tourism and software. Isthmus Partners also works with a number of institutional funds to provide management consultancy advice on their portfolio or target companies.

In the real estate sector, Isthmus Partners advises management on real estate developments, from feasibility studies to late stage projects. The partners have worked on restructuring a number of real estate deals in Dubai including Sports City and The Marina.

Isthmus Partners' services include investment project health checks through financial due diligence, feasibility studies, monitoring of ongoing projects to ensure greater control through cash flow monitoring models, and advice on business and financial strategies.

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