

FAQ – Opportunities For Investors Arising from the South African Business Rescue Process

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INTRODUCTION

The South African business rescue process has created the opportunity for investors (local and foreign) to position themselves in order to take advantage of distressed assets in South Africa and which could potentially be acquired through the business rescue process provided for in Chapter 6 of the South African Companies Act, 71 of 2008 (the Act). The business rescue mechanism in South Africa has created a new playing field for investors, venture capital, hedge funds, private equity firms, third party potential acquirors and distressed funds to consider the potential of acquiring good value assets at significantly discounted prices. With the onset of tough trading conditions caused by economic and energy crises, and with many businesses likely to seek the protection of the business rescue mechanism, there is no doubt that investors and potential acquirors of businesses will be looking to the mechanisms of Chapter 6 for acquisition and M&A activity.

In this publication, we deal with certain of the most frequently asked questions (FAQ) arising from this "asset class" of investment and having ourselves been involved in certain significant transactions flowing from opportunities that have arisen in the business rescue space.

SINCE SA INTRODUCED ITS BUSINESS RESCUE LEGISLATION IN 2011, HAVE WE SEEN AN UPTICK IN "DISTRESSED DEBT" ACQUISITION ACTIVITY AND IS THERE VALUE IN THIS MARKET?

Firstly, some background on the business rescue process – since 2011, SA has seen a marked increase in financially distressed companies applying for business rescue. If a company is financially distressed (that is, it cannot pay its ongoing creditors in the next six-month period or will become insolvent on its balance sheet in the next six-month period) then the board of directors must consider placing the company into business rescue. A business rescue practitioner would be appointed to supervise the company's affairs on a temporary basis while the company is being restructured or potentially sold to a third party. There must be a realistic prospect that the company can be rescued. If not, then the company should be placed into liquidation.

Whilst the company is going through its restructuring process, a moratorium (stay) on all claims would exist for the duration of the rescue period. No creditor can enforce claims against the company, attach its assets or apply to court to wind up the company (place it into liquidation) whilst the company remains in business rescue. Once appointed, the business rescue practitioner would engage with all stakeholders (creditors, management, directors, third party suppliers, employees and trade unions) in an effort to draft a workable and realistic business rescue plan which would be aimed at rescuing the company. Debt due to creditors would be restructured with most creditors being asked to agree to a compromise of their claims. The company can, once a plan has been voted in (all creditors vote on the value of their claims, in one class and which includes secured creditors), exit the rescue process and which can result in the company continuing to trade on a solvent basis or alternatively, where the plan allows for the company's business/assets or shares being sold to a new owner, and where creditors end up receiving a better dividend in business rescue than they would have received in a liquidation. In certain instances, there is an opportunity to do a "pre-packaged" buy-out and where a deal is consummated up front and then approved (in an expedited fashion) in a business rescue process.

Many of these companies have ended up being acquired by third party investors (locally and from offshore) and where either the shares or the business/assets have been acquired at substantial discounts. Generally, these parties have made an offer of say R1 for the shares and have in addition offered creditors something better than they would get in a liquidation scenario. Generally negligible dividends are available to creditors in liquidation (if at all). In almost all instances, creditors vote in the business rescue plan...why would they not? Clearly a business rescue dividend of 30 cents/50 cents in the Rand is far better than a zero/negligible liquidation dividend which would be the outcome if the business rescue plan is not approved, and the company is forced into liquidation.

DOES THE LEGISLATION SUPPORT ACQUISITIONS OF FINANCIALLY DISTRESSED COMPANIES AND HOW DOES THIS WORK IN PRACTICE?

Chapter 6 of the Act incorporates the business rescue legislation and provides a robust and effective mechanism which is aligned with similar procedures available in international jurisdictions. It is a creative mechanism and if approached in a manner which allows for the beneficial outcome for all stakeholders, can result in good value assets being acquired through the process. Confidence in the business rescue mechanism continues to increase. The South African courts have delivered numerous judgements interpreting the provisions of the Act so that it can be applied in a practical and meaningful fashion. Competent business rescue practitioners are being appointed to deal with the sale of certain of these assets/businesses out of these distressed companies and as a result, we have seen more and more investors and third party acquirors looking at the procedure to make these acquisitions. As has been said, business rescue in South Africa is fast becoming the new "M&A" and there is no doubt that acquisition activity in distressed companies is on the increase.

WHAT ARE THE TIME LINES IN GETTING THESE DEALS DONE?

The business rescue legislation contemplates the process ending after a period of three months, although in practice often these periods are extended with the consent of creditors and particularly where more time is required in order to finalise the acquisition transaction. The timeline indicates the manner in which a potential offeror can successfully acquire a distressed company/asset. Issues such as the provision of post-commencement finance (PCF), when to make the offer, (which would be conditional on the business rescue plan being approved by creditors) and the manner in which the provisions of the plan are to be implemented, are all essential issues that need to be considered. The aim, of course, is for the successful acquirer to exit the rescue process with the company intact and with good value having been achieved.

CAN YOU GIVE US SOME EXAMPLES?

There are numerous examples where companies have been successfully restructured by way of an acquisition of the shares or business/assets of companies that have gone into business rescue. These opportunities are varied and occur across various sectors. Examples to date include – Pearl Valley Golf Estate (acquired by Standard Bank), Southgold Mine (acquired by Sibanye Gold), Top TV (acquired by a Chinese company Star Sat), Meltz Success (acquired by the Hub), Advanced Technologies & Engineering (Aeronautical) Engineering (acquired by Paramount), Moyo Restaurants (acquired by FourNews), Optimum Coal Mine (acquired by Liberty Coal) and SA Calcium Carbide (management buy-out). In addition, Phumelela Gaming and Leisure (was acquired by an investment consortium), Edcon (Edgars acquired by the Retailability Group and Jet Stores by the Foschini Group) and Fairmount Zimbali (acquired by the Capital Hotels Group).

More recently, we have seen acquisitions in the mining sector such as Andalusite Mine (acquired by MIKKEL Trading), and in the sugar industry, namely the acquisition of Tongaat Hulett by the Vision Consortium.

WHAT ARE THE TARGET SECTORS?

There have been opportunities in mining and resources, manufacturing, airlines the sugar industry and in retail. Top TV was a satellite TV offering and Aeronautical Engineering was a company manufacturing armaments on helicopters. Phumelela operates in the horseracing and gaming industry and Edcon operated in the retail sector. Acquisitions in business rescue is thus industry agnostic, and is not limited to any particular sector. It is a mechanism, which if used effectively, can result in any distressed company being acquired through the process.

IS THERE INTEREST FROM FOREIGN INVESTORS AND DO THEY HAVE CONFIDENCE IN THE SA BUSINESS RESCUE MECHANISM?

Yes certainly. Eric Levenstein has spoken on this topic in Beijing, London and in New York. There is international interest in the distressed asset-based market in this jurisdiction and where emerging markets in South Africa and in Africa are being considered by offshore Distressed Funds, Venture Capital and Hedge Funds. South Africa is seen as a new "unsaturated" market for distressed asset investment. Distressed Funds (funds set up specially to acquire distressed companies) is big business in places like Australia and the USA. The establishment of such Distressed Funds is catching on in South Africa and we are starting to see a host of new local distressed fund players entering the market and where they are holding funds available to put up post-commencement funding and funding for acquisition purposes.

IS THERE A NEED FOR POST-COMMENCEMENT FUNDING OF THE COMPANY TO KEEP IT AFLOAT WHILST THE TRANSACTION IS BEING BEDDED DOWN?

Post-commencement funding – known as PCF – (in the US, it is referred to as DIP funding) is the lifeblood of any business rescue process. Without it, there is a good chance that the rescue process will fail. A company that is being restructured or is being acquired by a third-party acquirer must be able to pay its ongoing expenses during the business rescue process thus allowing the company to survive. If not, the company will have to go into liquidation. The company might not need PCF if its continued trading can allow it to "wash its own face". If this is not possible then, PCF must be put up by alternative sources. PCF can be put up by existing lenders (banks), the company's shareholders or by the third-party acquirer. The third-party acquirer would have to put up PCF to prop up the company, while the acquisition transaction is being bedded down. Any PCF provision would be ranked as superpriority (preferent) in the business rescue process. The legislation allows for the business rescue practitioner to make provision in his/her plan to pay back the PCF provider in preference to other creditors. The provision of PCF is thus essential in keeping the company afloat and which allows for the retention of value. If not, there will be nothing left to acquire.

CAN EXISTING PREJUDICIAL CONTRACTS BE TERMINATED?

One of the issues that the business rescue practitioner must deal with is existing contracts that might be prejudicial to the company, and which might prejudice the company's ability to continue trading and which might be an issue for the prospective purchaser. The practitioner is entitled to suspend/vary existing contracts that are in place during the period of business rescue, or apply to court to cancel these contracts. The counterparty would have a claim for damages against the company, if this were to occur. This option does give the practitioner flexibility and allows him to deal with these prejudicial contracts on an urgent basis and in pursuing a successful restructuring of the financially distressed company.

CAN ONE REPLACE THE BOARD OF DIRECTORS?

Management (and the board) can be replaced during the business rescue process. Particularly where management might have committed fraud or where management are so inept that they need to be removed. Often it is the board and management that have brought the company to its position of financial distress and thus it makes sense to have management and the board replaced by a more effective management team. The counter to this of course is that the business rescue practitioner comes into the matter cold, and with no real background knowledge of the trade, dealings, and financial affairs of the company. He/she would have had very little opportunity to have become acquainted with all of the intricacies of the business and the way it has been conducted. Thus, getting rid of existing management and the board might be counter-productive and could result in a failed business rescue. It is a balancing act, and the approach would differ from company to company and would depend on the ability of the business rescue practitioner to effectively work together with existing management and the existing members of the board to pursue a successful turnaround or sale of the company.



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