RESTRUCTURING DISTRESSED PRIVATE EQUITY PORTFOLIO COMPANIES IN KENYA AND BEYOND – AN OVERVIEW

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COVID-19 and other market factors, both local and global, have negatively impacted certain sectors, as well as operating businesses generally. Private equity funds may well have investments in portfolio companies, which may be experiencing near-term (and potentially long-term) declining revenues, liquidity constraints and potential challenges to servicing debt.

Where the business fundamentals of such distressed portfolio companies are sound, there may be a number of restructuring options available to a portfolio company and its fund and other shareholders. However, for a successful implementation of a restructuring option, action must be taken at the earliest stages of distress rather than at a point of no return.

There are three main stages a company goes through when it is in financial difficulty. The first is underperformance; this is where a cash generative business losses profitability. The signs here are subtle, but with close attention, it is in this phase that the company has its best chances to effect a restructuring. The next stage is the distress stage. This is where the business cannot fund any of the company's activity outside its immediate operations and it has difficulty meeting its commitments to its lenders or its trade creditors. Action taken in this period is still useful, though the options and the environment for a successful restructuring may be more limited. The final stage is the crisis stage where the company faces a critical shortage of cash, forcing it to use all of its cash generated by the business to service its debts. By this time, the company is either insolvent or on the brink of insolvency.

What Next if a Portfolio Company is in Distress?

Where the fund's portfolio company may be facing financial distress, as a first step, the fund should consider ensuring that the portfolio company undertakes an independent business review (IBR). The IBR would give the fund and other shareholders and the company itself an indication of the stability of the portfolio company at a given point in time and the financial viability in the short- to medium-term. It will also highlight areas of concern that need to be addressed for the portfolio company to operate successfully. If the results of the IBR reveal areas of concern, then the following options should be considered.

Operational Restructuring

Operational restructuring is the identification of the causes of operational underperformance and the development of a strategy to achieve improvement. Operational restructuring focuses on the profitability of operations. It does not address the capital structure or financing structure of a company.

With most turnarounds, operational restructuring and balance sheet restructuring (discussed below) should be considered together, not independently.

Balance Sheet Restructuring

A balance sheet restructuring refers to the restructuring of components of the business that form part of the reporting on the balance sheet. This is usually implemented by concessions made by debtholders and equity holders of a company in an effort to make the balance sheet stronger. Stronger in this context can mean a number of things but inevitably involves the company having less leverage than it did before.

One element of a balance sheet restructuring could be injection of additional capital to improve cash flow. Liquidity may be injected into a portfolio company by equity or debt.

General Corporate Considerations

Prior to injecting capital, the fund should consider: (i) whether the group/portfolio company can survive on its own resources; (ii) if not, what amount of additional funding should it provide and in what form; (iii) what are the fund's rights and obligations vis-à-vis the portfolio company in this situation, in particular, what do its own fund documents and the specific portfolio company's shareholders agreement (SHA) provide; and (iv) finally, is there a possibility of third-party financing (either a white knight or lender) and what will be the impact on the portfolio company as a result.

Even prior to the above, the fund can look at whether it has fully exercised its appointments at the board level and, if it has not it should ensure it is fully represented on the board in line with its rights in the SHA and consider carefully the composition (and expertise) of the management team. Particularly, a key question for shareholders is whether the management team is sufficient and efficient or should it be streamlined and specialist expertise be recruited.

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Debt Funding

Where a fund is looking at debt financing as a way to raise capital for its portfolio company, then there are several key considerations that it needs to take into account, including:

- the portfolio company's leverage ratios;
- what are the funding provisions in the SHA? Are there emergency funding provisions? Indeed, as a practice point, a private equity fund should consider including such provisions in the SHA upon its initial investment. The same question is applicable on an equity financing (see below);
- contractual obligations and/or restrictions on incurring additional debt;
- whether any structure of debt financing may be treated as a voidable transactions under insolvency laws; and
- attendant costs related to any proposed structure of the debt financing (and the restructuring of the current debt obligations, if necessary).

Equity Funding

For equity financing, the fund will wish to consider:

- what are the funding options and restrictions for the private equity fund at the fund level?
- are there any emergency funding provisions contained in the SHA (as indicated above, this is something a fund should consider including at the negotiation stage of the SHA and prior to its investment)?
- what are the consequences of dilution if the fund has no more capital to inject into the company or is otherwise restricted from doing so by its fund documents or investment committee?

Portfolio Company's Lenders

Another element of balance sheet restructuring is reducing leverage. This, amongst other options, may be done by way of covenant waivers and resets, debt waivers or haircuts, extended maturity dates, payment rescheduling combined with company led contributions such as non–cash capital contributions or debt for equity swaps for shareholder loans.

It is important that all stakeholders, the portfolio company and its shareholders (including the fund) begin negotiating and discussing the portfolio company's financial situation with its lenders early in the process to ensure that the lenders are part of the process from inception. In this way the lenders are more likely to give some of the concessions discussed above. Generally, financial institutions are reluctant to enforce security unless all avenues for rescuing a company have been explored and, as such, shareholders and the portfolio company itself should ensure early engagement with any lenders is undertaken to maximise lender buy in.

If no white knight can be found and the fund and other shareholders are unwilling to inject capital then some form of consensual or statutory restructuring is inevitable as set out below.

Consensual Restructuring Versus Statutory Process

Any restructuring may be implemented consensually or by using a statutory process. The path to be used would be determined on the facts of each scenario. Where there are fewer key stakeholders and creditors, it is possible to effect a restructuring by consensus of all affected stakeholders. This type of restructuring will require early, honest and open engagement with the company's lenders and other key parties.

However, where there are multitude of creditors, a formal restructuring process would be more of appropriate to effect any restructuring of the portfolio company.

> A key question for shareholders is whether the management team is sufficient and efficient.

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What Are the Available Statutory Processes in Kenya?

If it is not possible to effect a restructuring in a consensual manner because the relationships with key stakeholders have broken down or there is a misalignment of stakeholder interests or for any other reason, then it is possible for the private equity fund to consider the following statutory processes to implement any restructuring. We have set out below the processes and options available in Kenya, however, the processes available in other African jurisdictions may vary.

Schemes of arrangement - it is an arrangement carried out between the company and a particular class of members or creditors. In order for a scheme to be effective, it needs the approval of a majority in number of the creditors or members (as applicable) representing 75% in value of those creditors or members. The scheme must be sanctioned by the court and a copy of the sanction order must be filed with the Registrar of Companies in Kenya. This is not an insolvency procedure and can be used by both solvent and insolvent companies.

Pre-insolvency moratorium - this is a procedure that can be used by the directors of eligible companies to obtain temporary protection from creditors, while the company considers a business rescue plan. There is no eligibility threshold for a company to qualify for the moratorium, provided that the applying company is in financial distress. The moratorium will be for a period of thirty (30) days but the court has discretion to extend the moratorium for further thirty (30) days. This process must be supervised by a "monitor" who must be a licensed insolvency practitioner.

Administration - this insolvency procedure allows for the reorganisation of an insolvent company or the realisation of its assets under the protection of an automatic 12-month statutory moratorium. It is conducted by an administrator who must be a licenced insolvency practitioner in Kenya.

Company voluntary arrangements - this is an insolvency procedure that is proposed by the directors of a company which allows a company to satisfy debts owed to creditors by paying only a proportion of the amount that it owes or coming to another arrangement with its creditors for paying back the debt. It is usually used to restructure unsecured creditors. It is supervised by a supervisor who must be a licenced insolvency practitioner in Kenya.

Liquidation - this is usually the last resort in most cases where numerous efforts to rescue a company have failed. It spells the death of a company and is conducted by a liquidator who must be a licensed insolvency practitioner in Kenya.

Other Considerations: Director's Duties in Kenya

Inevitably and as part of the control rights acquired by the fund, it will have appointed directors to the board of the portfolio company. These directors will have the same fiduciary duties as all the other directors of the company. The Kenyan Companies Act codified previous common law duties of directors in regard to their conduct and to possible liability if they fail in their duties. The duties owed by a director to a company are altered where that company is in or is facing the threat of insolvency. In those circumstances, directors have a duty to act in the interests of the company's creditors as a whole (i.e., to preserve the value in the company in order to maximise the return to creditors).

This is important because the Kenyan Insolvency Act provides for two statutory offences of wrongful and fraudulent trading which could result in the directors being personally liable if they are found culpable. Wrongful trading is usually a case of poor judgement or denial where the directors continue to trade when they know that there is no reasonable prospect of the company avoiding insolvency. Current and former directors can be found liable. Fraudulent trading is where the directors knowingly carried on trading with no intent to pay their debts.

Directors can mitigate the risk of liability by taking proactive measures such as holding regular board meetings which are fully minuted, closely monitoring the company's financial position, ensuring that directors who are nominees do not have conflicts of interest and seeking legal and financial advice early. The decision on whether to stop trading should be kept under review at all times.

Conclusion

Whilst a portfolio company in a distressed situation is not ideal for the fund or any other stakeholders in such company, in order to rescue and bring such portfolio company back to operating profitably, some of the key criteria to successful turn-arounds are:

- identifying issues early and acting quickly and decisively;
- to have a joined-up approach with buy-in from shareholders, the portfolio company (including its management), lenders and its other creditors; and
- for the fund to expect the unexpected and ensure provisions in the fund documents and the portfolio company's SHA to allow for expedited emergency funding.

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