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LEGAL PRACTITIONERS

DISTRESSED M&A AND THE ZAMBIAN BUSINESS RESCUE PROCESS



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ONE MAN'S LOSS IS ANOTHER MAN'S GAIN

Introduction

- A new orientation of insolvency law in Zambia, yet to be tested
- Glimmer of hope for private sector amid declining business conditions
- Investing in distressed assets, one investor's loss can be another's gain

Zambia has 'operationalized' the business rescue mechanism, first introduced in July 2018 under the Corporate Insolvency Act No 9 of 2017, which allowed a one-year window period for the formulation and promulgation of the subsidiary legislation.

The Corporate Insolvency (Insolvency Practitioner) Regulations Statutory Instrument No. 40 of 2019 and the Corporate Insolvency (Forms and Fees) Regulations Statutory Instrument No 41 of 2019 (the "Regulations") were published on 26 July 2019.

Up until last year, entities in financial distress generally ended-up in receivership or liquidation, a process that had limited statutory support to encourage rescue of the business. The business rescue framework represents a significant shift from a pro-creditor to a pro-debtor culture in Zambia's corporate insolvency landscape.

Announcing the coming into force of the Corporate Insolvency Act in 2018, the Zambian Minister responsible for commerce, trade and industry hailed the significance of the business rescue mechanism:

"This will safeguard against financially troubled but potentially viable companies always having to end up in liquidation but have a chance to be resuscitated."

Given the current economic headwinds, the introduction of the Regulations is timely. In May 2019, the Central Bank of the Republic of Zambia, issued the Monetary Policy Statement for the first quarter, an assessment of current domestic and international economic conditions along with the outlook for Zambian inflation and output growth, which referred to certain upside risks, and raised the local policy rate by 50 basis points to 10.25 per cent, the first rate hike in four years. A hike in interest rates increases borrowing costs for a business.

The unfavourable business conditions for the private sector in Zambia is reflected by a subdued Purchasing Manager's Index (PMI) reading which has been below 50 for ten consecutive months, spelling declining business conditions in the private sector and contraction of the economy.

In terms of economic outlook, the World Bank forecasts a slow down of growth at 2.5 per cent in 2019 and remaining below 3 per cent in the medium term. While the IMF in its recent August 2019 Article IV consultation statement forecasts growth to drop to 2 percent and remain subdued going forward.

Why business rescue

Protecting a potentially viable business in financial distress is the key priority of a business rescue process although there are other desirable outcomes such as preservation of employment and achieving a better return for creditors.

The business rescue mechanism allows a financially distressed business with reasonable prospects of viability to seek a second lease of life.

Business rescue can be triggered in two ways (a) voluntary business rescue by the board of directors passing a resolution; or (b) compulsory business rescue by any 'affected persons' including a regulator, shareholder, creditor or an employee, and a former employee of a company making an application to court for a business rescue order.

The advantage of business rescue is that when the resolution for voluntary business rescue is filed or the court makes a business rescue order, there is a temporary moratorium on the rights of claimants and the company is placed under the temporary supervision of a business rescue administrator. This allows the company some breathing space to have its business affairs restructured in a way that:

- (a) maximises the likelihood of the company continuing in business on a solvent basis; or
- (b) yields a better outcome for creditors and shareholders than a liquidation would achieve.

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The business rescue administrator must, within 30 days of appointment, develop a business rescue plan in consultation with the creditors for the restructuring of the business affairs of the company.

There however, must be timely identification of financial distress because, if liquidation proceedings are initiated, the option of voluntary business rescue is not available. Directors of a company in financial distress need to be proactive in identifying financial distress and taking the appropriate action if there are prospects of a turnaround. If they fail to do so, they need to be mindful of their duties to creditors in terms of the Companies Act including potential personal liability for fraudulent trading.

The ability of the business rescue administrator to raise post commencement funding (PCF) is critical to meet short term trade obligations and the restructuring costs during the business rescue process to keep the business afloat. This also presents an opportunity for financiers such as private equity funds, distressed funds with the requisite risk appetite to provide distressed funding for the business rescue process in the form of PCF.

Opportunity for investors

Business Rescue presents an opportunity for both local and foreign investors with 'dry powder' to deploy to acquire distressed assets in the business rescue process at potentially discounted prices.

Various strategies can be employed such as the 'loan to own' strategy that involves acquiring the senior debt of an ailing target, which provides control and leverage during the sale process.

Another way is to provide the PCF, which effectively sponsors the business rescue process and gives the funder a seat at the table.

The process is not without risk, however as typically the transaction will be conducted on an as is basis with very limited representations and warranties.

There is also a higher degree of risk as there is likely to be limited information for diligence since management who may have been responsible for the demise maybe let go by the business rescue administrator who will have full management control of the company. Accelerated timelines are also the norm since in terms of the Act, once a business rescue plan is filed it must be completed within the prescribed time frame.

What does the future look like?

Given the macroeconomic headwinds, investors with the risk appetite to purchase distressed assets through the business rescue process, stand to gain in a turnaround.

Further, the rise in non-performing loans (NPL's) for the local banks and the rising portfolio of foreclosed properties, makes business rescue a more palatable option for the banks to unlock much needed liquidity.

However, to succeed, the legislators may need to reassess the receivership option under the legislation to promote a rescue culture and discourage banks from choosing receivership over business rescue. In addition, it will require a change in mindset from a receivership or liquidation culture to one of rescue.

The economic outlook suggests that opportunities for distressed M&A will only increase in the coming years. So far, only **one company has been placed under business rescue** whose sale is reported to be completed next month.

We remain to see whether there will be a significant increase in companies voluntarily applying for business rescue and whether this will generate the desired confidence in the process on the part of creditors and interest from foreign and local investors. Overall there must be a certain level of proactivity on the part of all stakeholders, directors and creditors alike.

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