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Deloitte Africa Agribusiness Unit (DAAU)
Prosper and grow

Management of risk accounts - Turn around strategies

Content

The management and turnaround of Agribusinesses in financial distress is a systematic and calculated process which can take between three to five years to turn around

Absolute commitment, as well as discipline, is required by all participating parties. It is therefore important that all relevant creditors are involved to a lesser or greater degree, depending on their interest. Moreover any action taken should meet with the approval of the financiers of the business. They should also be involved with the whole process as to be able to make the necessary recommendations for approval.

Although business owners are normally well aware of increased financial difficulties, the problem normally manifests itself by way of arrear accounts, non-payment of accounts and dishonoured cheques. If left to late, no remedial action can be taken which results in a business going bankrupt with resulting financial losses to all parties involved and leaving destitute workers in the wake of the disaster.

Accounts are in arrears as a result of non-payment of debt which normally is a function of:

- Insufficient cash flow/income due to climatic reasons (this is normally a short term problem)
- Inefficiency of enterprise or enterprises due to lack of resources, managerial ability and lack of industry knowledge
- High overhead costs, for example labour cost or number of dependants/families relying on income from the farming unit
- Incorrect financing structures (short, medium and long term debt to assets should correspond)
- High debt ratio and capitalisation of interest (specifically a function of lack of equity/own contribution which lessens risk carrying capacity)
- Farming with low income enterprises
- Incorrect marketing systems resulting in low margins
- Rapid changes in enterprise type in an effort to improve repayment ability (cost of changes between enterprises to try and revive profitability actually worsens financial position)
- Lack of risk mitigation ability, skill and strategy in order to adjust to changes in the agricultural environment
- Non-productive use of assets

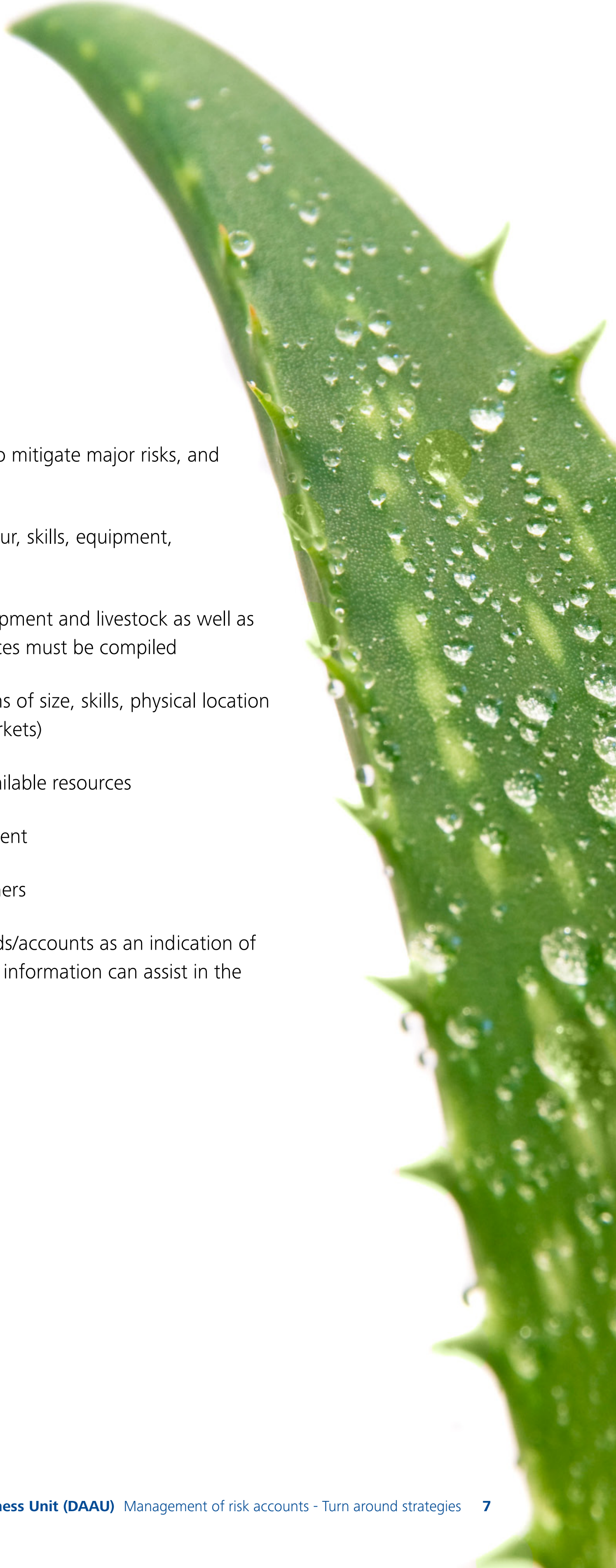
When addressing the problem of the correct turn around strategy to follow, solutions can range from as simple a solution as restructuring of debt, complete restructuring of the business, sale of assets or reapplication of assets. At worst it could also mean liquidation of the total business in order to salvage remaining equity in order to start a new venture.

Should debt be at levels where no remedy can be found in terms of improved profitability, it would be best practise to retain portions of the business e.g. cattle and sell of the rest to repay debt. By retaining this liquid asset, farming operations can be continued on rented land. The business owner is the key person who should enable the turn around as he/she is the person that has to implement the proposed change.

In order to create a base from which any corrective action can be taken, certain steps need to be followed. These normally are a resource, enterprise, market/industry, skills and broad business environment analyses to determine what changes or adaptations are possible and practical. Identification of risks that contributed towards the current financial problems is necessary and risk mitigation steps is required as part of a final solution. A host of possible risks needs to be taken into account, some of these include:

- Enterprise
- Concentration
- Marketing and commodity
- Interest rate
- Technological obsolescence
- Climate logical risks

Resource analyses



The resources need to be scrutinised to mitigate major risks, and could include:

- The availability of land, water, labour, skills, equipment, fixed improvements
- An inventory of all properties, equipment and livestock as well as their respective realistic market prices must be compiled
- The limitations of resources in terms of size, skills, physical location (e.g. remote rural and far from markets)
- Assess the true potential of the available resources
- Knowledge and skills base assessment
- Likes and dislikes of operators/owners

Check on availability of business records/accounts as an indication of proper budgeting and planning as this information can assist in the analyses of the current enterprises.

Enterprise analyses

In the enterprise analysis the following should be considered:

- Conduct a detailed analyses of each of the current enterprises in terms of profitability and efficiency.
- Determine the return on investment of each enterprise and measure against business average cost of capital - the aim is to determine whether an enterprise is able to generate more than the average cost of capital.
- After determining whether enterprises are performing below or above cost of capital determine whether corrective measures can be taken to improve low performing enterprises.
- Should it not be possible to rectify over short to medium term then evaluate liquidation income of the enterprise and its resources (e.g. equipment).
- Simulate the use of capital from this source into the highest performing enterprise (expand the best enterprise first), taking into account the availability of resources. Should resources be a limiting factor then capital should be applied to the enterprise that has available resources or to repay debt.

It is of critical importance that the correct income and expenditure is used in the calculations of gross margins as understatement of costs and overstatement of income will lead to incorrect conclusions

A simple guideline is to rely on the audited income statement as this should give a true reflection of historical costs.

Testing of the accuracy of the expenditure can also be done by means of enterprise budgets obtained from reputable sources such as Agribusinesses or co - operatives. A key factor is to note that different enterprises have different costing percentages and relates to income potential. Normally the lower the gross income, the lower the cost of production and vice versa.

The selection of high income potential enterprises as a possible solution to financial problems will therefore put pressure on already stressed working capital availability. The adage of the higher the reward, they higher the financial risk is also applicable.

Trying a new high value enterprise as a solution is therefore rarely an option given capital requirements and skills level required.

Industry analyses

Each of the respective enterprises should be analysed in terms of its industry peculiarities. Specific attention should be given to the power of suppliers of inputs (where they can dictate prices and producers do not have a choice but to purchase at a non-negotiable price) or buyers that are able to fix prices. In both instances the profit potential is constrained unless it is possible to advance in the value chain.

Investment in enterprises that are capital intensive with specialised equipment that do not have a resale value also pose a risk with regard to choice of possible turn around or exit strategies (poses a barrier to exit as to huge financial losses being incurred). Life cycle is also of importance as mature markets tend to be less profitable.

The producer should have in-depth knowledge regarding the industry that he is part of and must understand the driving forces behind it and be aware of key success factors

Part of turn around strategy is to build on your advantages such as being a low cost producer of a commodity due to high efficiencies. Other advantages may be the proximity to markets or ability to supply products in bulk which can reduce marketing and packaging cost.

Options and risk mitigation

From the enterprise and resource analysis a clear picture should present itself regarding the risks that have contributed to the current problems for example climate (low yields), marketing (low commodity prices), enterprise type (cyclical downturn due to over supply of commodity), and low profitability due to high costs (intensive animal enterprises e.g. dairy, pork, poultry).

Enterprises that act as a cash drain will have been identified as well as reasons other than risks that contributed. Different options can be identified as to what is required to improve profitability and sustainability given the environment in which the business is conducted.

Logical reasoning is necessary and however difficult, emotion must be kept out of decisions that are made. In order to be pro active, action plans should be compiled in order to make provision for alternate plans should a proposed option not realise.

Cut off dates in terms of sale of assets (should it be required) must be given, taking into account that it be realistic given market conditions. Given the current financial performance of an account that has to be turned around, availability of outside investors capital is normally not an option as a solution. This is against the background that investors require a good track record with above normal returns.

Simulations and scenarios

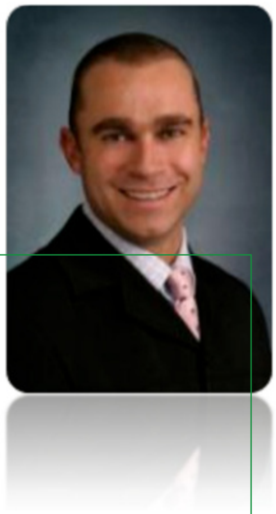
After completing the analyses, simulations of the possible solutions are required. Strategies or combination there of must be applied in order to determine which creates the best solution with an acceptable risk.

- Immediate sale of non-productive assets.
- Sale of one or more farming units given that net sales price per hectare is higher than the debt per hectare. Keep in mind that income on bonded properties is first applied to debt for which the property has been given as collateral. Any release of a portion of income derived in this way is subject to the financiers approval. The same applies to any other item whether movable or immovable that has been given as collateral.
- Liquidation of an enterprise and its associated equipment to decrease debt - this is done in instances where the return on investment is lower than the average cost of capital
- Re allocation of capital obtained by means of liquidating an enterprise into current enterprise that performs at a ROI higher than average cost of capital. Investment may not only be to increase the size of the enterprise but can be in terms of value added products in the supply chain.
- Sale of redundant equipment to invest in the most profitable enterprise.
- Total liquidation of assets on a voluntary basis (at your own time within a specific time limit). Forced sales normally result in assets not receiving true value as most buyers are attracted to "bargains". Experience has taught that one rarely realise more than 70 % of market value of an asset due to commissions and legal cost.

In tabling the proposed turn-around strategies it is important to note that all the combinations be given and that the risks associated with these strategies also be mentioned. Risk mitigation is an important part in a turn around and financiers normally want to see whether their credit risk has been decreased or not.

Once a solution has been accepted by all parties, management of this strategy is crucial as to meet all mile stones and to adjust when necessary. Use of the original budgets and cash flows as compiled as a solution must be the golden thread from which the required result should flow

Contacts



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