

REGIONAL ANALYSIS: CANADA

A view from the precipice

BY ALLAN NACKAN

In recent months, much has been written about the global financial crisis and its impact on businesses around the world. To date, Canada has fared relatively well, but there are few safe havens from the financial meltdown facing the world's capital markets. From a Canadian perspective, and perhaps an international one, many business leaders feel like they are balancing precariously on the edge of a precipice. There does not appear to be much good news on the horizon either.

For Canada, which depends heavily on trade with the US, an increasing number of corporations are likely to be dragged down by events south of the border. On the one hand, to date Canada's economy has yet to feel the full impact of the credit crisis. Thanks to a highly regulated banking sector and more conservative lending practices, the country's banks suffered relatively modest write downs. Total exposure to non-bank issued asset backed commercial paper in Canada totalled \$33bn. Although final resolution of that problem is not yet settled, that debt has been restructured in what has been dubbed the largest and most complex restructuring in Canadian history.

On the other hand, organisations can no longer pretend that events in one country will remain contained. We live in a global economy, which means continuing deterioration in the US and global economies will likely spill over into Canadian markets. As availability to credit remains tightly controlled, stock market turmoil persists and consumer confidence plummets, Canada's economy is poised to see an inevitable dramatic slowdown.

For corporations, the implications of this situation are potentially severe. When lenders were awash in 'silly money', struggling organisations often received lifelines that pulled them back from the brink of failure. In an environment of deepening financial crisis,

however, the refinancing and restructuring of companies has become more challenging due to a number of factors.

First, debtor-in-possession (DIP) funding, which is the lifeblood of any successful restructuring, is already drying up across North America. Facing balance sheet troubles of their own, several DIP lenders have vastly limited available financing. Some US lenders have even closed their Canadian operations.

Second, corporations that face life-threatening liquidity challenges may find they lack the capital to fund operations through a restructuring. Historically, an excess in liquidity, combined with soaring asset valuations, ensured willing lenders were plentiful and opportunities for renewal rife. In an age of complex capital structures and declining valuations, companies are often saddled with multiple layers of debt, limiting their ability to attract new lenders, even at today's soaring rates.

Third, despite the streamlined restructuring process available in Canada (restructuring under the Companies' Creditors Arrangement Act (CCAA) tends to be more streamlined than US Chapter 11 proceedings), the costs of restructuring are still perceived as prohibitive.

Fourth, capital availability from traditional sources is also drying up as traditional lenders begin to limit their annual credit renewals. Companies may find themselves stymied by bankers unwilling to shore up their poor financial performance. These challenges are likely to bubble to the top in 2009 and 2010, driving the next wave of corporate failure.

Finally, in a market where liquidity was plentiful, many lenders found themselves entering sweetheart deals at unreasonable valuations and with limited financial covenants. These loose lending practices are now plaguing the portfolios of banks, hedge funds and

asset-based lenders, who may demonstrate themselves increasingly averse to making or perpetuating risky investments.

In light of these trends, struggling corporations are more likely to face the prospect of liquidation than in the past. This is a trend already playing out in the US, where quick sales under section 363 of the Bankruptcy Code are being favoured over more drawn out and costly sales/reorganisations under Chapter 11. 363 sales are accomplished in as little as two to three months, often with the feature of a 'stalking horse' bidder. This methodology is increasingly prevalent in Canada too. Yet even liquidation sales are becoming less viable. Going concern sales are at lower multiples and the traditional buyers of liquidated equipment, both domestically and abroad, now find themselves awash in an oversupply, driving asset values to exceptional lows.

Nestled among much of the negative coverage, there remain small rays of hope: Companies that have access to cash are in a most favourable position. Organisations with strong management and robust risk management practices have an unprecedented opportunity to acquire distressed assets at extreme discounts. Numerous financiers and private equity funds have already shifted to pursue distressed deals.

Amid this doom and gloom, it may seem companies lack any choices. In truth, corporate options do dwindle if financial troubles are left to fester. To avoid a worst case scenario, companies need to seek restructuring advice as early in a down cycle as possible to maximise their options for response. ■

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