

Liquidation

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Going, going, gone

The financial storm is leaving behind a trail of destruction in Hong Kong and the mainland, writes *Joyce Ho*

The financial crisis has wreaked havoc on Hong Kong and mainland China, uprooting companies and leaving among the rubble empty factories, rusting machines and stacks of winding-up petitions.

A slew of companies have been in provisional liquidation since October, including listed fashion retailer U-Right, jewellery retailer 3D-GOLD Jewellery and toy manufacturer Smart Union Group. Private electronics retailer Tai Lin Radio Service and U.S.-based doughnut chain Krispy Kreme also filed for liquidation in the same month.

“We haven’t seen the worst yet,” says Nick Gronow, executive director at Ferrier Hodgson, whose firm is the provisional liquidator of publicly-listed watchmaker Peace Mark and swimwear manufacturer Tack Fat Group International. Both went into provisional liquidation in September.

Insolvency practitioners say Hong Kong will see a spate of liquidations in the next six to nine months, with manufacturers, retailers and mainland developers being the most susceptible.

“When the market turns in the way it has in the last few months, and when so many factors gather together at one time to create an almost perfect storm, we expect that the economy will experience

a rough ride for two to three years,” says Patrick Cowley, a principal in the restructuring and insolvency division of KPMG China’s advisory business. The firm is one of the provisional liquidators appointed by court to deal with the collapse of Lehman Brother’s businesses in Hong Kong.

Hong Kong’s economy suffers from the quintessential ingredients to whip up that “perfect storm” Cowley describes. First, the collapse of structured financial products, followed by the tightening of bank credit and the looming recessions and job losses in the United States and Europe have sapped consumer confidence and spending. That in turn has sharply reduced orders for manufacturers at a time when their profit margins are squeezed by the rising yuan and higher commodity and labour costs resulting from the new Chinese labour law that took effect in January.

“Between now and Christmas, retailers in Europe and the United States are gearing up for the Christmas trade. Products for this trade are finished now and we were told that mid-October was the deadline to dispatch these to the overseas markets. So, I imagine now is the time to exit factories if manufacturers want to get out,” says John Lees, who runs his own firm offering business advisory, corporate

recovery and forensic accounting.

Insolvency specialists say it is tough to accurately gauge the number and size of companies the financial crisis will take down. Until recently, compulsory winding-up orders have been declining, falling from 1,147 in 2004 to 849 in 2005, 552 in 2006 and 455 last year. But the number stood at 386 for the first 10 months of 2008, slightly higher than the 383 cases in the same period last year, while compulsory petitions presented rose to 521 for the first 10 months from 492 in the same time last year.

Hong Kong retailers, especially the high-end ones, are bleeding. “It’s one of the toughest among all industries,” says Derek Lai, national leader of reorganization services of Deloitte China. “They usually don’t have a lot of assets. They may be committed to long-term, expensive leases when they have to sell their products at discounts.” Deloitte is the provisional liquidator of 3D-GOLD and U-Right.

Mainland developers, including those listed in Hong Kong, are also facing serious liquidity issues, Lees says. Many property projects that commenced amid the real estate boom in recent years ground to a halt before completion as firms ran out of funds, with sagging sales and tightened lending. Even if the developers could sell the flats, they sold

at steep discounts and in many cases, they could not cover the development costs, he says.

The financial turmoil has not left the gaming city of Macau unscathed. Up to 11,000 construction workers lost their jobs as U.S. casino giant Las Vegas Sands announced last month it had suspended work on the huge development in the former Portuguese colony until the company could secure additional financing.

Cautious creditors

Amid such volatile market conditions, firms in need of corporate restructurings have had trouble raising funds.

“Banks are now much more nervous and suspicious,” says David Kidd, head of the Asian business restructuring group at law firm Allen & Overy. “In the past, they waited a long time before taking steps to appoint a provisional liquidator. But they don’t wait as long at the moment. They are pulling credit lines almost immediately, which indicates a high level of nervousness.”

Banks, which often represent 70 percent to 80 percent of creditors of Hong Kong enterprises, are reverting to the old fashioned way of lending, Kidd says. They are stepping up due diligence, lending only to trustworthy enterprises at interest rates that properly reflect the risks of the businesses. They also closely watch out for companies showing the slightest sign of trouble, such as deteriorating margins, over-reliance on short-term debt, constant change in management or accounts and rising receivables on the balance sheet, says KPMG’s Cowley.

According to Danny Lau, chairman of the Hong Kong Small and Medium Enterprises Association, one of their members is expected to soon liquidate his firm after all of his four creditors either completely withdrew its credit line

or asked the company to fork out extra cash to make up for the difference in falling valuations of its collateral.

The member, who had a credit line of about HK\$20 million, is planning to sell his factories and even his home to repay the debt before winding up his company, which has operations making car seats for the United States, Japan and Korea, Lau says.

“This slew of events took place in the space of only four to five weeks. The member, although he could have arranged for corporate restructuring and perhaps been able to save his company, has decided not to do so because he felt betrayed by the banks,” says Lau.

Although the Hong Kong government already announced a scheme to help small and medium enterprises by guaranteeing 70 percent of their loans granted by participating lenders up to a maximum of HK\$1 million per enterprise, industry representatives say the move is inadequate.

“A cap of HK\$1 million may be good enough for small-sized enterprises, but it is definitely insufficient for medium-sized companies,” Lau says. “The situation is worse with new loan applications. Banks are not granting new loans at the moment, regardless of the aid offered to SMEs by the Hong Kong government.”

In the face of such a dire operating environment, Lau says companies have little means to improve their cash flow except to actively collect their receivables. He says his organization is advising its members to cut expansion plans, be prepared for a decline of 20 percent to 25 percent in revenue this year versus last year, and negotiate better payback terms with raw material suppliers who are also facing a cash crunch.

Restructuring experts say distressed companies wishing to sell part or all of their operations are trapped in a buyers’ market, where investors have a plethora

of attractive investments to choose from.

“With adversity comes opportunity,” says KPMG’s Cowley. “Asset valuations have already come down, which creates great opportunities for investors that have the financial capability to do deals, especially deals that don’t require leverage.” Peace Mark, for instance, said in late October at least 80 parties showed interest in buying some of its assets and it agreed to sell its luxury timepiece retail businesses to Hong Kong jewellery retailer Chow Tai Fook.

Hindrances

So what gets in the way when insolvency experts try to restructure a collapsing enterprise?

“One of the greatest impediments to successfully completing corporate restructurings in Hong Kong is when fraud is part of the equation,” Cowley of KPMG says. “The breakdown of trust between the stakeholders quickly undermines all of the effort that has been invested in the restructuring process.”

Gronow of Ferrier Hodgson says he expects to witness more insolvencies stemming from poor corporate governance. Companies adopting accounting practices that “bend the rules a bit” during good times often get caught in the wake of a credit crunch, he says.

Insolvency practitioners say leaving things too late is another big problem; financial advisors for corporate restructuring and banks need time to turn a business around but little can be done if liquidation proceedings are already launched against it. Unfortunately, advisors often do not get involved until too late – usually at the banks’ request – because the companies tend to think they can overcome their financial difficulties and refuse outside help, Gronow says.

Saving troubled enterprises that



have holding companies in Hong Kong when a substantial amount of their assets and operations are in mainland China is also tough because Hong Kong lenders tend to cut credit and withdraw financial help immediately. That is because under mainland regulations, local creditors have priority over their foreign counterparts when demanding compensation from an enterprise going bust, insolvency practitioners say.

Mainland Chinese authorities have the right to seize and freeze assets such as factories and machinery owned by Hong Kong companies but located in the mainland. Once that happens, owners and financial advisors are forbidden to

enter the premises and can't show the assets to potential buyers, clearly throwing a wrench into the corporate restructuring.

Reshaping insolvency

Insolvency practitioners believe it is high time for the Hong Kong government to revisit provisional supervision, a statutory corporate rescue mechanism similar to that of the U.K. and Australia, and to Chapter 11 reorganization in the United States. Provisional supervision gives companies a moratorium and some breathing space to formulate a rescue plan.

The bill was first proposed along with Hong Kong's Companies (Amendment) Bill to the legislature in 2000 but

the government shelved it following opposition from unionists. At present, apart from provisional liquidation that adds costs and delays restructuring, there is no formal process that provides a moratorium to protect a financially ailing company against its creditors while efforts are made to restructure it.

"Hong Kong hasn't learned the lesson," says Kidd, saying most Asian countries, including Korea and Thailand have new, similar legislation.

KPMG's Cowley says Hong Kong pales in comparison against China, which implemented a new bankruptcy law in June last year. China now has provisions allowing the court to supervise restructurings.

"Without provisional supervision, or any other formal rescue legislation, we are still relying on an informal out-of-court process. This lack of formal rescue legislation is another significant challenge when attempting to restructure businesses in Hong Kong as, without it, we have no moratorium unless provisional liquidators are appointed. We need to try and achieve a consensual work-out by keeping all the different lenders on the same page and focused on the same goal, which can be very challenging," Cowley says.

Apart from resuscitating the bill, Deloitte's Lai says he would very much like to see amendments to the mainland legislation so that Hong Kong creditors would rank the same as their mainland counterparts on the insolvency of a company.

"Right now, everything has to be done separately between mainland and Hong Kong creditors, which is difficult for restructuring," says Lai. "It would be advantageous for Hong Kong corporate restructuring and liquidations if the legislation in China and Hong Kong were identical or consistent with each other." **A+**