The failing firm test—part 2: no viable restructuring

1. Although a company might have been on a path towards failure, the second criterion of the failing firm test is that there were no viable restructuring options available which might have reasonably saved the company and enabled it to continue trading independently. According to the CC's guidance, the relevant test is whether, in the light of the evidence, the business was unable to restructure itself successfully.[1]

2. This appendix presents a summary of the evidence we reviewed, with regard to both an operational and a financial restructuring of GVI.

Operational restructuring

3. In the summer of 2006, shortly before the acquisition by Thermo, GVI's Technical Manager performed a review of GVI's operations, with a view to considering what restructuring would be necessary were the transaction with Thermo not to complete. His report was sent to Tony Williams (Managing Director). The Technical Manager identified several necessary remedial steps, which are set out below with our assessment of their practicability:

   - 'Reduce salary costs by £300,000 a year.' The majority of these savings are identified, in particular affecting the R&D department. In our view, given the submissions from management and competitors that the company spent too much on R&D for new products, these savings may have been achievable. However, it is unclear how the removal of these posts would have affected the longer-term viability of the business.

   - 'Reorganize the production area, designating a clear team leader to resolve mismanagement problems.' It is our understanding that [✂].

   - 'Stop under-selling product, requiring a minimum gross factory margin of 55 per cent on all sales.' It is our understanding that this action is seeking to address the past mis-selling of product, which has achieved short-term cash but been unprofitable. The recommendation recognizes that some products might not then be offered for sale if a profitable margin cannot be achieved.

   - 'Remove the AP2003 from the product portfolio, ideally by selling to [✂].' [✂] has submitted to us that, early in 2006, it was interested in purchasing the AP2003 from GVI. [✂]

   - 'Sell all remaining quad ICP stock.' It is our understanding that this stock is old, relating to the Platform product, which GVI had stopped selling. However, it is unclear how much this stock would have been worth, and which companies might have been interested in buying it.

   - 'Focus development on increasing margin rather than new product development.' We note that this action is seeking to address the ineffective ambition of the directors, which sought to create new leading products while existing customers were becoming increasingly disgruntled with products that did not work.

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[1] *CC2*, paragraphs 3.61 to 3.63.

- ‘Maximize cash recovery from excess stock.’

4. [✄]

5. Despite these recommendations from second-tier management, there is no evidence of any attempt by the former directors of GVI to reduce costs within the company prior to the transaction with Thermo. Monthly overhead costs (including all wages) increased from 2005 to 2006.

6. The former directors of GVI recognized the need for a restructuring. Indeed, the potential redundancy programme that they had in mind went further than that recommended by GVI’s management. The former directors submitted that:

> Had Thermo not acquired the business, GVI would have been in an extremely difficult position. We would have implemented a redundancy plan to have eliminated almost 50% of the workforce, but obviously there would have been costs involved and a time-lag to see substantial benefits. In order to maintain production, satisfy our order log and maintain cash flow, these redundancies would have had to come disproportionately from R&D and marketing. This would have had serious consequences for our long term ability to compete in the market. We would have continued to seek new investment to ease the chronic cash flow problems which were the root of our difficulties, however we were not optimistic about finding such investment. Had another buyer not come along it is likely the company would have gone into liquidation.

7. Soon after its acquisition of GVI, and prior to the OFT accepting interim undertakings, Thermo commenced an operational restructuring of the business. These changes were implemented with a view to integrating GVI with Thermo’s existing operations and therefore cannot be considered as the steps which were necessary to keep GVI independently viable, but they provide some indication of the restructuring of the business which Thermo decided was necessary. Thermo’s UK HR director, prior to the transaction, reviewed GVI’s staff lists with a view to evaluating potential savings. He estimated annual savings of £[✄] by removing the three executive directors, and £[✄] by removing [✄] other members of staff. Subsequent to the transaction, Thermo did indeed reduce GVI’s headcount, in particular by removing the directors, several personnel from R&D and severing all GVI’s agency agreements. Thermo made these cuts as part of a strategy for all new product R&D to be undertaken in its Bremen office, leaving the GVI R&D team to undertake only rectification work on existing products. These cuts might not have been viable for GVI independently of Thermo. Similarly, Thermo intended its existing international sales force and agents to sell GVI product in addition to existing Thermo product, which also would not have been an independently viable option.

8. This evidence, combined with the persistent losses and cash-flow problems identified in Appendix D, suggest that the operational restructuring which GVI required was not small. In order to return the business to profitability, the steps required were significant and would have been costly to achieve. It is doubtful that GVI could have independently afforded or delivered these changes. It is also doubtful that, at the time of the transaction with Thermo, these changes could have been implemented sufficiently quickly to safeguard the ongoing viability of the business.

Financial restructuring

9. Thermo argued that ‘a necessary pre-condition to successful re-organisation was a cash injection; however, given the state of the company’s position the prospects of

such a cash facility being available would appear to have been very remote'. GVI certainly did need a significant source of new funds: to settle debts with suppliers and re-establish supply chains, to continue to service debt financing, to rectify problems with customers who had been sold faulty goods or on delivery deadlines which were unachievable, and to implement a significant operational restructuring programme.

10. GVI had a strong order book at the time of the transaction with Thermo but, as the former GVI directors submitted, 'converting the substantial order log into cash would only have been possible by the injection of a large amount of money (>£2million) which we were unable to secure'.

11. GVI was at the limit of its debt funding from commercial sources, with no new security available on which to gain further funding: GVI was already factoring its debtors, its stock was already subject to a floating charge, it had no property or other material assets, and even the directors' life assurance policies had already been offered as personal guarantees. Internal emails within GVI's bank demonstrate that it was keen for its loan to be repaid and would not have been willing to extend its debt funding further without a significant new equity investment.

12. The GVI directors had already increased their loans to the business to almost £1 million, which they charged at an interest rate of 11.7 per cent. The directors could have assisted short-term cash flow by reducing the interest charge or converting some of this debt to further equity, but this option does not appear to have been considered. Given the directors' awareness of the precarious state of the business, it is difficult to conceive of them continuing to invest further in the business, either in debt or equity.

13. In March 2006, GVI was approached by Judges Capital, a UK instrument group. Following several discussions, at the end of May, Judges set out 'rough parameters' of an offer: a loan of £1.5 million for which it received an equity stake of 51 per cent; the GVI directors would keep their investment in the firm (their diluted equity and loans) and have their salaries cut. Judges submitted that the basis of its offer was that it would take immediate control of the company and there would be 'some serious belt-tightening'. However, the former GVI directors considered these terms too onerous, rejecting the offer and not pursuing anything further with Judges.

14. Thermo argued that the Judges offer was unlikely to have resulted in a completed transaction to successfully rescue the company, for a number of reasons:

- Judges was unlikely to have been aware of the extent of GVI's financial crisis and, had it undertaken due diligence, its interest in the company might have ceased.

- Judges' indicative offer would have required GVI's other debt holders to vary their debt claims which might not have been agreed.

- Judges' offer also did not address the issues with the Waters licence, which, due to the change in control of the company, would have had to have been renegotiated, possibly increasing GVI's costs by [✄] per cent of all future sales.

- The cash injection of £1.5 million offered by Judges was unlikely to have been sufficient to release GVI from its vicious cycle with suppliers.

- The Judges offer was only indicative and 'private equity firms tend to assess many potential prospects but progress only a small subset to completion'.

15. In our view, if the transaction with Thermo had not been completed, and if GVI's bank was agreeable, it is likely that the GVI directors would have gone back to Judges to see if its earlier offer was still available. At this time, GVI would have been in an even more perilous position and Judges' negotiating position even stronger. For the reasons listed above, it is highly unlikely that Judges would have maintained its existing offer. Indeed, as Judges preferred to invest in healthy companies, it is highly unlikely that it would have made any offer at all. If Judges had made an offer, it is very unlikely to have been in support of the existing management team and would rather have more likely been an effective buyout of the company, with the imposition of a new management team.

16. In June 2006, GVI received an approach from St Paul's Capital. A representative of St Paul's Capital visited the company and received an investor presentation. In July 2006 he requested a further visit, but by then the deal with Thermo was almost complete and the GVI directors declined. We have sought to contact St Paul's Capital but have been unable to do so.

17. In our view, the significant cash injection which would have been required to rescue GVI, in a high-risk investment where significant operational restructuring was also required, is likely to have made the terms offered by any potential equity investor highly onerous for the current investors. Given the history of the company under the former GVI directors, it is unlikely that many investors would have made such a high-risk investment in support of this team. Rather, any new equity investment, by Judges or another firm, is more likely to have been on the basis of a management buy-in. Although the former GVI directors did not actively seek new potential equity investors, with only one actively interested party there is little basis for considering that, at the time of the transaction with Thermo, a successful independent financial restructuring was likely.