That sinking feeling [1]

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EXCERPTS

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Nothing spells corporate disaster quite like a $100,000 kitchen sink. The sink in question was no different to the many others installed in the thousand-odd ABC Learning childcare centres across Australia, but its price tag saw it plucked from obscurity during the marathon public examination into the childcare operator's collapse. How do you spend $100,000 on a sink?

It was one of many peculiar practices brought to the attention of the Federal Court hearing into the collapse.

An ABC contractor, Queensland Maintenance Services Ltd, would overcharge on capital items such as the sink and undercharge on cleaning expenses. The understated expenses would, of course, overstate earnings, while the inflated capital expense would overstate one of the few tangible assets propping up ABC's balance sheet.

All of this was allegedly conducted at ABC's insistence, or, more specifically that of its founder, Eddy Groves.

It was one of many not-so-subtle ways that ABC's financial facade was massaged into shape.

The more controversial developer payments made to ABC was another. According to the ABC chairman, David Ryan, this facade remained intact until Groves was ejected from the company at the end of September, 2008. It then collapsed, to reveal - much to everyone's surprise - a company that administrators now believe may have been insolvent for many months.

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But did Groves - and ABC's byzantine business model - really bamboozle ABC's other directors, and small army of bankers through most of 2008 into believing the only challenge facing the childcare operator was its debt load in the wake of a massively changed financial market?

This does not appear likely to satisfy the administrators who conducted the examination. And if ABC is put into liquidation next month, as expected, potential legal action against its banks, auditors, and directors is among the only potential assets the liquidator can hope for unsecured creditors.

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Groves insists he was just an entrepreneur who relied on expert advice which ultimately failed him. It is a point he emphasised in an interview soon after appearing before the court earlier this month.

''I never claimed to be a corporate guru or corporate governance expert or a finance expert. The opportunities presented themselves, and I followed that dream and passion,'' he told The Australian.

For Ryan, who was head-hunted to ABC's board precisely because of his corporate and financial expertise, there is no such excuse. Especially since he chaired the audit committee which oversaw the financial reports that were still being restated when ABC collapsed.

But Ryan has his story too. Apparently there were two ABCs. One was behind the facade. It was a ''broken'' business model, as Ryan describes it, reliant on a high-volume pipeline of centres developed with closely related parties which became corrupted over time.

In interviews with regulators, Ryan says he later found out payments to developers exceeded what the board was told, as were the prices ABC paid for the centres.

The second ABC, the childcare fantasy that the directors were aware of, was a far healthier operation which needed to sell assets and de-leverage to appease the market gods in the wake of the global financial crisis.

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In the early weeks of the examination, ABC underlings described a company being run with a wild abandon that would not have been tolerated in its childcare centres.

All roads lead to Groves, who was depicted as the only one who actually knew how the business worked - or, as it was later proven, didn't work.

Cash constraints were apparent as early as April 2008 with creditor bills going past their due date. This included tax payments which opened ABC to the prospect of audits, ''which is the last thing we need'', as ABC's acting finance chief, John Gadsby, told Groves by email in mid-May.

Groves denies there were any cash constraints and says he didn't think the late tax payments were ''an extreme situation''.

Ryan was also included in on the email and obviously disagreed. ''I agree, John, it's a real worry,'' said Ryan, who directed Groves to make the payment. It may not have escaped Ryan's attention that ASIC regards overdue taxes as an indication that a company is at risk of insolvency.

What the banks were aware of at this stage is literally the billion-dollar question, given the syndicate - dominated by Australia's big four - received security over the entire childcare business from ABC's board in June that year. They also insisted the agreement include the direction of hundreds of millions of dollars from the asset sales to pay back debt the banks had raised for ABC just six months earlier.

The administrators are expected to attempt to overturn the transaction if ABC is put into liquidation, and may also seek the return of the loan repayments.

For the board itself, the awarding of security is one of many deals they approved during that tumultuous year that are under a cloud as questions are raised about when exactly ABC was insolvent and who knew exactly how much trouble it was in, and when. The who, what and when could determine whether certain directors face criminal charges, and personal liability for company debts.

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On June 10, 2008, ABC's corporate adviser from Goldman Sachs JBWere, Christian Johnston, sent an email to Ryan about an impending capital-raising with a division of Morgan Stanley. The email reads: ''$80 million to $90 million probably not enough to give the company the breathing space we think it really needs over the medium term. Having said that, it is clearly better than going under in the short term...''

''I was pretty annoyed when I got this email,'' Ryan told the court, describing it as being ''cobbled together quickly on the fly'' with Johnston taking ''an emotional position''. Ryan was asked what was meant by Johnston's email. ''I think Mr Johnston was concerned that by placing 15 per cent of [ABC] shares with Morgan Stanley, we would forever damage the underlying value of the shares in the company.''

Ryan later added that when a corporate adviser is contemplating loss of bidding tension in a takeover, they are not contemplating insolvency. For Ryan, the transaction was part of a mission to ''de-risk and de-leverage'' the business ''in a very difficult environment''. ''By August that mission had been accomplished,'' he told the court, citing $800 million raised from various sales.

By the end of September Ryan had fired Groves as chief executive and a director. Within weeks, ABC's new executive team slashed Grove's forecast earnings before interest, tax, depreciation and amortisation from $265 million to $62 million. Soon after, they would be explaining to the banks that ABC would not be able to trade out of its troubles and they would be placing the company into administration. That was the start of November 2008.

But if Ryan's response to Johnston's email seemed strange, his ignorance of the fact that it was entirely consistent with Goldman Sachs's dire forecasts of ABC are even stranger.
Goldman Sachs presented a report to ABC's board on April 17, codenamed Project Abacus, which highlighted liquidity concerns at ABC. The investment bank became involved with ABC after its disastrous interim results, released nearly two months earlier, triggered concerns about the company from which it ultimately never recovered.

The report presented to the board that day included the dire prediction that ABC would run out of cash by the end of June and breach its bank covenants if it did not sell off assets or find some other way to raise cash.

Ryan claims Goldman's dire forecast was only mentioned in the executive summary, which was not brought to the board's attention at the meeting. ''I did not read it, for if I read it I would have remembered it,'' he told the Federal Court.

Groves and ABC's then chairman, Sallyanne Atkinson, say they were aware of the report and these findings.

Atkinson, who left ABC the following month, even acknowledges there were concerns about ABC's liquidity - something Groves and Ryan deny.

These concerns were subsequently addressed with the asset sales, she said. Mission accomplished, once again.

Groves and Ryan agree on one thing, though: both discount Goldman's harsh forecast. ''I always felt there were other options for ABC,'' Groves says. But Groves also believes that ABC was viable right to the end and should never have ended up in administration.
He has no doubts where the problems began. ''I think the outside world changed dramatically with the global financial crisis,'' he told the court.

Groves says asset sales were the solution to the company's need to neutralise the short sellers in the market, who were targeting ABC due to its debt. ''The only way to do that was to de-risk and de-leverage.''

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Aside from the security given to the banks in late June, just before Goldman Sachs forecast the company would run out of money, Ryan acknowledged that ABC recorded a $278.5 million loss on the deconsolidation of its US assets after selling a majority stake in the business. It was an acceptable price to pay, Ryan says.

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But testimony from representatives of ABC's bank syndicate reveals there was certainly concern of some sort after the release of ABC's interim results in February 2008.

According to the Commonwealth Bank executive acting as agent for the bank syndicate, the earnings result was below the forecast given to the banks just months earlier when they raised $1.43 billion for the company.

This would have concentrated the minds of the banks. As most of ABC's assets were intangible, its earnings profile was crucial to its perceived credit risk with the banks.

''The credit metrics were no longer reflective of the position put to them in November 2007,'' says Ian Wunderlich, who heads the Commonwealth Bank's agency division. Senior executives within the bank also closely scrutinised a compliance certificate from ABC which lobbed a day after its interim results were released on February 25. The document said ABC remained compliant with debt covenants.

By that Friday, February 29, Eddy Groves was flying to the US to begin negotiations over the sale of the US assets, while ABC's banks emailed the company requesting confirmation that it had maintained compliance with its debt covenants ''at all times'' since December 2007.

The inevitable consequence of this was the security the banks now required over ABC's assets. It effectively delivered the whole company to them when it collapsed in November, and has left nothing but potential legal actions for ABC's unsecured creditors.
More importantly for ABC, the interim result effectively shut down bank credit as a source of cash for the company at a time when its operating cash flow was negative and up to $200 million worth of centres were in development that had yet to be paid for.
The $82 million share placement at rock-bottom prices in June signalled that this was also exhausted as an avenue to raise cash which emphasised, in retrospect, that without the asset sales it was game over.

But it did not become apparent to the board that this was the case until October 2008, when newly appointed executives had shredded the credibility of financial information Groves had provided to ABC's banks just weeks before.

Groves had already been turfed from ABC but was still available to help out the new executive team, which included its chief financial officer, Peter Trimble.

On October 9, 2008, the two met in a Brisbane office to try to reconcile Groves's $265 million earnings figure with the reality they were uncovering at ABC.

''He just wanted to understand the science behind my numbers,'' Groves told the court.
None of Groves's science bridged the $200 million earnings gap that the new management team was uncovering. It would prove terminal for ABC within weeks.

If Trimble was unimpressed with Groves's ''science'', then the feeling was mutual.

He evidently was not impressed that ABC's new management team relied so little on advice from the man who had built the empire from scratch.

When counsel for the ABC administrators, Michael Cashion, asked Groves about his impression of Trimble from the meeting, he replied: ''Mr Cashion, he had not one clue.'' Plenty more would be happy to join this queue.

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