Turnaround 101 for Financially-Strapped Companies

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With the a prolonged recession, and significant changes in the dynamics of so many markets, companies have struggled with cash flow, fought with funding sources, and worried that they may not have sufficient liquidity to satisfy customer needs. Lenders have become increasingly intolerant of covenant defaults, and increasingly demanding with respect to renewal of credit facilities, often asking for enhanced equity positions by sponsors. To create and maintain sufficient liquidity, performance improvement measures are no longer an option; they are a necessity. This article offers basic steps that should be considered to improving performance for financially-strapped companies.

Step 1: <u>Get Some Breathing Room With Your Lender</u>

When companies get short on cash, it invariably results in them tripping financial performance covenants with their lenders that typically need to be maintained and exceeded to be in compliance with lending requirements. When financial covenants are broken, lenders, of course, worry whether or not the company will be able to support its debt levels and become far more intrusive, pressuring the company for voluminous documentation on the financial performance and prospects of the company. This pressure often results in the company becoming less communicative or becoming combative with the lender. Such approaches are rarely useful as the lending documents provide the lender with lop-sided powers to shut the company down, collect accounts receivable, sell-off collateral and in some instances, offset any deficiency between receipts from liquidating assets and the debt (and debt enforcement costs) by collecting on a guarantee of the owner.

Even though lenders have the power to shut-down a financially-strapped companies, they are often reticent to use these powers because of the difficulty of being made whole – i.e. collecting the full amount of the debt. At the same time, approaching a lender in a combative manner or "going radio silent" won't lead to the desired outcome either.

The best way to get some breathing room with a lender is to retain an outside "turnaround" professional who can restore credibility with the lender. When a business moves into financial stress, lenders and equity sponsors will begin to question all aspects of the business from the validity of the numbers to the viability of the business plan. The funding sources will, of course, be reluctant to throw good money after bad.

An independent turnaround professional (who has credibility in the lending community) can vouch that the numbers provided are valid and that the business plan is solid (or help revise it to make it compelling to the funding sources). The turnaround professional will give the company a fighting chance to get back on its feet.

Step 2: <u>Get Your Arms Around The Cash</u>

Once a turnaround professional is identified and retained, the next step is to determine the true cash position and cash needs of the business. Obviously, when a company is financially-strapped, the last thing that would seem to make sense is to hire an expensive outside professional. However, often times a turnaround manager will analyze cash needs of the company for a small upfront fee, and then assist the owners in developing a financial plan with funding sources that will not only to pay for operational needs but also pay for the turnaround manager to affect the desired turnaround.

The turnaround professional will work with the company to develop a 13 week cash flow which will show on a weekly basis the cash needs and projected cash position of the company. Embedded in the initial cash flow will be "low-hanging fruit" changes in operations which can enhance cash flow so that the funding sources see that change is afoot. Because the company is working hand-in-hand with an experienced professional whom the lenders trust and who will track projected and actual results on a weekly basis, the lender may begin to have renewed confidence in the company and its prospects.

Step 3: <u>Make Sure You Are Situated To Develop A Robust Business/Change Plan</u>

After cash needs are analyzed and additional funding is achieved, the next step is to develop a business plan with buy-in from all constituencies of the company – employees, owners, lenders and, in some cases, even customers and vendors.

It is a well known principle in the turnaround industry that the person who is responsible for operating the business and meeting daily customer demands rarely has the time to develop and drive changes in the organization that will enable it to find innovative operational methods and processes to improve the overall success of the business.

In addition, it is counter to human nature for a person who has done a task and sold goods in a certain manner for years to easily accept doing those tasks and selling those goods in a fundamentally different way. Even if a method is not working, it is much easier to continue using it, with minor adjustment, then making the radical changes that may be necessary to succeed in this very challenging business environment.

An effective turnaround professional will help lead the development of the new business plan and work collaboratively with ownership, management, and employees throughout the business to capture and incorporate their collective wisdom in the plan.

There are three keys to developing an effective business plan

1. The turnaround professional must be humble. Even if he has worked many turnaround plans for millwork companies, every company is unique, and the turnaround professional must work as a co-pilot with owners and senior managers, and get ideas/advice/comments from employees who do the day-to-day work

2. Buy-in must be obtained from all constituencies of the company – everyone, including lenders and equity sponsors, need to believe in the plan and all must be committed to executing it

3. Clear goals (or metrics) must be set so that everyone can know whether the plan is being achieve or not, and if it isn't being achieved, changes can be made so that the plan requirements are met.

Step 4: <u>The Business Plan Must Address Key Drivers of Success</u>

The business plan must evaluate how to improve the success of the selling effort and how to reduce costs; however, the underlying basis for all these improvements is the business being able to know in "real time" what is happening. One of the common characteristics of distressed businesses is that management and owners do not know soon enough the financial impact of their decisions and actions. This delayed visibility into financial results of decisions can ultimately lead to failure of the business. Accordingly, the business plan must address, as an initial matter, the technological and reporting shortcomings in the business so that everyone can know what is working and what is not.

The next phase in business planning is to address revenue drivers. A thorough evaluation must be made of how goods are sold, how salespersons/account managers are motivated, and how results are tracked and publicized. Do you have the right person on the right account? Are you maximizing use of your sales personnel? Does everyone in your company know who is effective and ineffective as a salesperson? How are you tracking results of your revenue-producing personnel?

Savings can usually be obtained through evaluating the cost lines of the budget. Key areas to check may include:

1. Contracts with Vendors: Can you get a better deal through concentrating purchases with fewer vendors or otherwise reduce or extend payment terms? Are vendors willing to explore new ways of working together and sharing risk?

2. Supply chain and logistics: Have we optimized our inbound and outbound logistics and stock rotation programs? Have we explored in-sourcing and outsourcing opportunities? Is there a bigger opportunity for recycling and reuse programs?

3. Product changes and product mix: Are we selling the right products to the right customers? Can we afford to keep every customer we have? Can product size or packaging be changed to save money?

4. Improved Use of Capacity and Production Processes: Can plants be consolidated? Can space be used more efficiently? Can production processes be improved?

The expense lines need to be evaluated. Can the company do more with less? Is there visibility into how money is being expended? Where are the savings opportunities?

Finally, opportunities to save on interest may be available to the Company. Reducing costs of money can result in significant savings, in those instances where these opportunities are available.

There are a myriad of issues that need to be addressed in business improvement plans. Often employees throughout a company will have numerous, high quality ideas to save or make money, but this resource has not been tapped and the employees are reticent to offer their ideas. Performance improvement plans may actually be quite easy to develop; it is necessary, however, to set up the focus and energy to create the plan and then ensure that it is implemented. All areas of the business must be thoroughly analyzed to identify inefficiencies and waste to allow more profit dollars to fall to the bottom line.

Step 5: Communication Is Critical

When trust has been broken, which is almost always the case when a company is in financial distress, over-communication is required. An effective turnaround professional will work with management to develop a periodic communication plan that brings clarity and visibility to business performance as a result of plan implementation. Company leadership must make it a priority to frequently update all employees to assuage their fears and keep them focused on achieving improved business results. Transparency and explanation of objectives and results with other constituencies of the Company is also imperative; this approach has a far higher success rate then “hiding the ball”. A competent turnaround professional can often quickly restore trust with a lender or other constituencies through straightforward communication and because of independence and reputation for integrity.

Conclusion

Operating a business in a distress situation requires a completely different set of skills than operating a growing business or a stable business. When you can barely meet payroll, vendors are threatening to bolt, and employees are uneasy, past experience in these types of situations is invaluable. In addition, it is essential to understand legal options, contractual approaches, “low-hanging” fruit adjustments, and optimal communication methods to navigate through the land mine of issues that will confront you.

When a company finds itself on the precipice, the stress on management is overwhelming. It cannot be emphasized enough that it is rarely optimal to try to do it alone to “save money.” A distressed company can increase its chances of success many fold by hiring the right turnaround consultant to help create a credible business plan, communicate with funding sources as to the success of implementation, and bring all the constituencies of the company – employees, management, owners, and lenders – together so that the company is able to survive and prosper.