

Looking for Signs of Trouble: The Nature of Vigilant Investment

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Today's investors need to develop an active, probing attitude toward the companies in which they invest. When investors can identify higher-risk times in a company's life cycle and the early warning signs of distress, they enhance their ability to perform due diligence on a company before investing in it, as well as their ability to monitor the health of companies once they are invested.

Companies, like people, have a life cycle. Sometimes the phases in the cycle are predictable, but often periods of crisis and distress develop unexpectedly. Initial rapid growth gives way to youthful missteps and adolescent independence. Adolescent adventures may create crises. Even those who do not rebel in their adolescent years are not safe, as adulthood often comes with its own set of pitfalls. People and companies both have life cycles mixed with rapid growth, missteps, and adventures. Unfortunately, it is also typical for people and companies to encounter distress and crisis eventually. Luckily, a vigilant investor can predict when times of distress are most likely to manifest themselves.

The following examples emphasize the importance of vigilant strategies for investors. They illustrate the need to seek outside turnaround expertise early because of the complexity of turnarounds that begin when a company's problems are already advanced.

EARLY INTERVENTION IS KEY

It is less likely that investors will be heavily reliant on a company's assessment of itself when they are familiar with the common danger zones that precede bankruptcies and restructurings. When investors determine a company is experiencing multiple danger zones at once or signs of distress are apparent, early action and a company's willingness to adapt can avert a significant restructuring or worse.

Some firms and/or their investors find it useful to consider engaging turnaround specialists with professional designations when they face major challenges. In the case of Los Angeles-based BMK, Inc., President and CEO Richard Craig found himself in a situation where his bank requested he engage a turnaround firm to address the causes of defaulted loan covenants. The issue was both unfortunate and mysterious as this \$400 million wholesale distributor's internal reports indicated the company was solvent following a rapid period of acquisition. Through a rollup strategy, BMK, Inc. had acquired 14 companies in 30 months.

"We didn't know what we didn't know," Craig said. "We were not getting good financial data because our underlying systems were never installed properly. A year ago I was looking at reports saying everything was fine." A turnaround firm helped diagnose the company's ills and remedy the situation.

BMK was operating without sufficient financial controls, one of the most obvious signs of corporate distress. BMK, with the guidance of the turnaround firm that had been retained, took decisive action and replaced the CFO and several of the divisional-level operating staff. They then began implementing the turnaround actions necessary. An interim COO and CIO were brought in to ensure the competency and integrity of BMK's operating practices and new financial systems.

Despite success in the turnaround efforts, unfortunately, a minority of the company's secured creditors (two out of 10) lost patience and chose to discontinue the out-of-court restructuring. BMK ultimately filed for bankruptcy and is currently in the process of being sold. Although the company is functioning today, considerable enterprise value was lost by the bankruptcy process. "I'd never wish this experience on anyone," Craig said of the bankruptcy, "but we're stronger as a company for having gone through it."

BMK's bankruptcy may well have been avoided entirely if diagnostic efforts had begun at the first signs of distress, instead of when loans were in real jeopardy. BMK's story illustrates how challenging a turnaround can be when a company's difficulties are advanced, even when management commits fully to resolving them.

WILLING PARTICIPATION IN A TURNAROUND IS KEY

Even when appropriate plans to revitalize a company are determined, the ability to implement is key. Leaders who participate willingly are crucial for a turnaround's success. However, in many situations, management presents a barrier to necessary change. When management is an impediment to repairing a company, more drastic action must be taken.

The story of Rick Ralston, the founder of the Hawaiian apparel company Crazy Shirts, sheds light on how an executive can be at odds with the very efforts to save his company. Ralston entered an untenable business situation when he purchased the Aiea Sugar Mill in 1994. Intending to refurbish the property and use the mill as the company's manufacturing headquarters, Ralston discovered that the costs to implement his plan far exceeded initial projections. This discovery coincided with the collapse of the Asian tourist market in Hawaii, which diminished Crazy Shirts' sales significantly. These circumstances, combined with an unsuccessful expansion effort, called for drastic action and a turnaround firm was engaged.

Ralston, however, is a visionary who transformed Crazy Shirts over 30 years from a single Waikiki location in 1964, where he single-handedly airbrushed designs on T-shirts, to a \$95 million company with over 40 locations. Following an outside firm's recommendations did not come easily to Ralston.

"I knew I was in trouble, and I wanted help, but I still had my own judgment as to whether recommendations are good or bad," Ralston said. After achieving so much success with his firm over so many years, Ralston found himself in unfamiliar territory when he needed to ask for help with his creditors, difficult real estate holdings, and swelling debt.

After interviewing several turnaround firms, Ralston engaged one company and subsequently fired them. Ralston grew to appreciate the professionalism and candidness of the second turnaround firm he hired. "They were experts in dealing with our trade creditors and landlords. They brought me creditability in dealing with my bankers. They also helped me decide which stores to close, how to surgically reduce costs, and how to best extricate myself from the Sugar Mill, as well as other properties," Ralston said.

But Ralston wrestled with the board of directors appointed as part of the debt forbearance agreement that was ultimately negotiated. "They were all superior to me in their experience and their knowledge of finance, but they didn't understand my business," explained Ralston. Ultimately, Ralston resigned as CEO of Crazy Shirts, and the company declared bankruptcy. Ralston decided to sell when he arrived at the inescapable conclusion that despite his best efforts he would be "working for the bank and would never get out." Accepting that fact was contrary to Ralston's nature. "Entrepreneurs always think they're going to pull things out of the swamp," Ralston explained.

The turnaround professional may find no alternative but to put in place a team that will lead the turnaround effort. Any manager, including top executives such as the CEO and CFO, who impedes the effort, should not be allowed to remain. A weak or unfocused board of directors should also be removed.

Whatever the course of action is in a turnaround, recognizing problems early, when they are manageable, can make the difference between a business continuing to be part of a portfolio or not. Vigilant investors continually perform analyses in order to flag oncoming trouble. Knowing common business danger zones and distress signals can help investors anticipate trouble and consider the possibility of early action.

SIX DANGER ZONES

One of the first steps to becoming a vigilant investor is being aware of likely danger zones that indicate a company may be in a precarious state. These danger zones are:

- Rapid revenue growth
- Systems conversions
- Over-expansion or aggressive acquisition strategy
- High debt to equity deal structures
- Low margin distribution channels
- Family matters in a family-owned business

The presence of any one of these danger zone items by itself may not be a cause for alarm. Any company experiencing two or more danger zones simultaneously, or in conjunction with any of the signs of distress (described on the next page), warrants close examination. The results may likely indicate a higher level of risk than an investor wants to assume.

In general, danger zones occur at times when dynamic change becomes a priority in a company's life cycle. An obvious example of dynamic change occurs when the company undertakes a merger. A less obvious example happens when a company converges its major systems. A proactive investor should question a company's ability to allocate the necessary resources to complete these changes successfully and scrutinize contingency plans.

Rapid revenue growth. Rapid revenue growth puts pressure on any firm's infrastructure. If management is already thin, control systems may not operate effectively. When control systems are compromised, pricing pressures increase and margins retreat because customer relations are ultimately affected.

Rapid revenue growth can also be a function of the company offering discounts or other incentives in order to accelerate sales. While promotions can be useful in raising product awareness, investors should be wary if such efforts are chronic in a company's marketing calendar or if the sales force has excessive discretion with discounts. Investors should be watchful of long-range sales and marketing strategies that may lower the perceived value of a company's offerings and brands.

Systems conversions. Enterprise resource planning systems, with fully integrated accounting and operating modules, can create efficiencies in most businesses. Unfortunately, almost no conversions go smoothly. Entire functional units of a business such as shipping and billing can be seriously

interrupted without adequate system migration plans.

Every formal conversion plan should include a thorough implementation and training plan, as well as a backup contingency plan. Contingency plans should take into consideration the possibility of running old and new systems simultaneously until it is clear the new system is operating correctly. Investors might even wish to speak to users and trainers of the current system in order to assess the level of risk the proposed conversion will add to a company's overall profile.

Over-expansion or aggressive acquisition strategy. Investors should closely examine expansion and acquisition strategies to see if they are supported by market research and to determine whether they are a natural evolution in the growth of the company. Investors should specifically question whether acquisitions will meet a growth objective more cost-effectively than expansion from within. This "danger" was a contributing factor in the difficulties experienced by both Crazy Shirts and BMK, Inc.

Unforeseeable circumstances or a lack of adequate due diligence to anticipate integration challenges often create lengthy and costly stresses. For instance, Crazy Shirts suffered a drop in the tourist trade following an expansion. BMK, Inc. discovered their financial data was not sound only after an aggressive acquisition campaign. These stories illustrate the necessity of investors requiring contingency plans that address dire scenarios, such as a 20% drop in sales. Anticipated resources, revenue, or competitive advantages may not materialize following an acquisition or expansion. Worse, the company may experience a reversal.

High debt to equity deal structures. This danger zone frequently goes hand in hand with the over-expansion and/or aggressive acquisition strategy. Acquisition transactions completed over the past several years frequently included ratios of debt exceeding equity by three to four times. If a downturn materializes, broken covenants create loan defaults.

As Crazy Shirts' story demonstrates, a fully leveraged new transaction leaves little room for missteps. Companies that borrow heavily and then stumble find themselves facing burdensome problems caused by the downside of the leverage effect. Management's ability to respond to market changes will be reduced by creditors' constraints. Constraints faced by borrowers become even more acute if companies begin to slide further downward. Furthermore, banks and financial institutions can be quirky, particularly in syndicated deals such as BMK, Inc.

Low margin distribution channels. The variety of distribution channels available for a company's products

and services provides an insight into opportunities to grow the business. In many instances, distribution into lower margin channels does not provide sufficient revenue to cover the company's fixed and variable expenses. Examining opportunities to expand distribution channels into higher margin activities creates improvement in earnings before interest, taxes, depreciation, and amortization result.

Family matters in a family business. Family businesses are challenging environments by their nature. Business decisions are sometimes based on or influenced by emotions rather than sound judgment. Equity sponsors and lenders need to be perceptive to possible friction areas, and the management of such firms should make specific efforts to include objective input for key decisions.

Contingency plans for a family business may need to address issues that would otherwise be private matters. Potential family issues such as a divorce are risks that can ruin a privately held or family-controlled company and need to be considered as such.

A sound succession plan to pass the management process from one generation to the next is crucial to the long-term survival of a family-run company. Even when such a plan is in place, the transition is often difficult. If no such plan is in place, deciding which relatives should run the business can impair or even destroy the company.

Investors should learn to identify these danger zones in order to assess the risks an investment presents at any given time. If they were road conditions, the preceding street signs would read, "Proceed With Caution."

EARLY DISTRESS SIGNALS

In addition to business danger zones, there are also clear signs of corporate distress, which may require immediate action. These include:

- Inadequate understanding of customer and product line profitability
- Ineffective management
- Lack of financial and operating controls
- Delay in keeping pace with market/technology changes
- Unfavorable Z-Score analysis results (*see Exhibit*)

The street signs that correspond to these signals of distress might read "Danger" or even "Do Not Enter." While most business owners, commercial bankers, equity sponsors, and shareholders never expect their companies/investments to become financially distressed, in real-

ity, one or more of these distress signals should be expected at some point during the evolution of a business.

Inadequate understanding of customer and product line profitability. It is important to remember that financial statements reflect the end result of company transactions. Companies must stay actively involved in providing customers with value in order to produce results. Value provided to customers may decrease as a distressed company attempts to alleviate its ailments, which in turn creates greater distress.

Margin improvement cannot be effective without a full understanding of the direct contribution resulting from customer and product line sales to the profit margin. Close analysis of this relationship often yields opportunities for efficiencies that can lower costs to service customers, including rationalization of stock keeping units and reduction of unneeded inventory.

Ineffective management. A company is only as good as its people and its leadership. If a company is troubled, investors need to know whether present management is capable of reversing a declining trend or is, in fact, the cause of the problem.

For investors, the crucial task of assessing a company's management can be difficult because gauging management's results as well as its individual members is highly subjective. Luckily, commonalities among effective managers allow investors to identify the people who can help reverse a period of distress. Managers valuable in a turnaround are able to consider the potentially troublesome facts of a situation and measure them against a reasonable degree of optimism, as well as provide clear thought and articulate communication to employees and the turnaround team. Few managers will confess to being obstacles to repairing a distressed company. Investors must regard actions as stronger than words.

The following questions can help investors focus their investigation regarding management:

Compensation

- Are investors' and management's economic interests aligned?
- What ownership stake does present management have in the company?
- What is management's present compensation and is it sufficiently linked to the success or failure of the company?
- Is the board of directors ineffective or inactive?
- Do the managers have clearly defined measurable goals or are they simply collecting checks?

Effectiveness

- Is there a lack of management depth or experience?
- Is management bureaucratic to the point of inefficiency?
- Is management top heavy compared to the rest of the company structure?
- How do managers justify the positions in their organizational chart?
- Which divisions are doing poorly and which are doing relatively well?
- Are managers accountable or are they reliant on management by committee?

Flexibility

- Are the C-level officers autocratic or interactive?
- How has management responded when a downsizing program has been initiated?

Lack of financial and operating controls. It is a clear sign of distress if a company is operating without adequate financial or operating controls. This can be demonstrated by financial reporting that is suspect or untimely, as in the case of BMK, Inc., which had positive financial reports and broken loan covenants simultaneously. When management decisions are based on old or inaccurate information, the company will almost certainly head in the wrong direction.

Financial records should be thorough and timely enough to permit trend analysis. For instance, investors should be able to determine if cash flow is generated by investments and financing or, preferably, by operating activities. Accounting practices must be sound and common sense should prevail. This issue is more relevant than ever in the wake of the Enron/Andersen/SEC/Department of Justice scandal. One positive outcome of these events is that more companies are reporting their financial data more thoroughly than ever, especially with respect to debt. Accounting records should be intact and accessible. Questionable records may be evidence of fraud or dishonesty. Records should reveal if the company is losing substantial sums to uncontrolled expenses or other money pits.

Delay in keeping pace with market/technology changes. Investors must pay attention when a company clearly falls out of step with industry technology or market shifts. Retail stores should have contemporary point-of-sale equipment, the same way a manufacturing concern should have up-to-date machinery on its manufacturing floor. Changes in the marketplace can leave a technically disadvantaged company with sagging sales and lost mar-

ket share. Investors should also watch whether a company's new products or services miss customer demand cycles, indicating the company does not identify market trends.

Industry news also needs to be monitored to assess a company's response to external forces. Companies should not be vulnerable to an industry revolution. For example, when advances in desktop publishing capabilities began to encroach on the typesetting industry, rapid retooling was necessary. Some typesetters went under, but others adjusted to the new technology or found unidentified niches.

Unfavorable Z-Score analysis result. Edward I. Altman, Ph.D., a financial economist and professor at New York University Stern School of Business, developed the Z-Score in 1968. Altman's model is an extremely useful tool to assess a company's financial health and take a snapshot of a company's likelihood of bankruptcy. His latest version is in the Exhibit. You can also go to www.scotlandgroup.com and compute the Z-Score for the portfolio company in question.

INVESTOR PARADIGM SHIFT

Only when investors actively look for red flags can they be involved in the maintenance and successful turnaround of their investments. If a company needs assistance correcting current conditions or must be assigned to the workout department of a financial institution, substantial unplanned demands are placed on the company. Weekly cash flow forecasts, collateral audits, independent valuations, pressure from customers and trade creditors, along with the demands for more communication to the firm's employees, are only a few of these pressures. It is during these unsettling times when companies need professional help more than ever, especially from certified turnaround professionals (CTPs) who have gained their professional designation through meeting stringent criteria in the areas of practical experience, knowledge, and integrity and successfully passing a rigorous examination.

All investors can help protect their investments and ultimately maximize returns by actively monitoring their portfolios, a fact that is more relevant today than ever. Although this kind of thinking requires a shift in attitude for most investors, those who commit to the process are more likely to minimize their losses, reap financial rewards, and experience greater engagement and commitment to the companies in which they invest.

EXHIBIT

The Z-Score

The *Z-Score*, developed in 1968 by Dr. Edward I. Altman, is an effective means of assessing financial health as well as predicting the likelihood of bankruptcy. Used with traditional financial analysis, the model is a worthwhile tool for managing an existing portfolio or as part of a loan approval process. It is a popular predictor because studies have shown it to be accurate more than 80% of the time. The Z-Score is also easy to calculate, despite its complex appearance.

Notice that the five components comprising the Z-Score formula are all ratio calculations themselves. Each separate component provides its own insight into the company's health, measuring items such as liquidity, leverage, profitability, valuation, and efficiency.

When market value of equity is not available, book value can be used in the *Z'* or private company models.

To calculate the Z-Score, figures should be taken from the latest company financial statements and market or book values. The trend over several years is the most important thing to observe. Z-Scores will normally range from -5 to +10, but can sometimes range above 10 if liabilities are low but equity value of a firm is high. The following table will help you to classify your results. Note the broad range of uncertainty and suggested "monitoring" range is roughly 1.8 to 3.0 for public companies. Companies with Z-Scores above 3.0 are generally considered healthy. Those with Z-Scores trending below 3.0 should be monitored. Companies without publicly traded stock have a lower threshold of distress because book values are usually lower than market value.

Altman's Original Public Company Z-Score Formula

$$Z = 1.2(X_1) + 1.4(X_2) + 3.3(X_3) + .6(X_4) + 1.0(X_5)$$

Where Z = Overall index of corporate health

X₁ = Working capital divided by total assets

X₂ = Retained earnings divided by total assets

X₃ = Earnings before interest and taxes (EBIT) divided by total assets

X₄ = Market value of preferred and common equity divided by total liabilities

X₅ = Sales divided by total assets

Altman's Revised "Private" Company Model

$$Z = .717(X_1) + .847(X_2) + 3.107(X_3) + .420(X_4) + .998(X_5)$$

Z-Score Results	Scores *		
	Publicly Held Manufacturing Company (Z)	Privately Held Manufacturing Company (Z)	Mfgr., Non-Mfgr. Industries & Emerging Market Credits (Z)
Low probability of bankruptcy	≥ 3.075	≥ 2.90	≥ 2.60
Company requires monitoring	3.075 – 1.875	2.90 – 1.23	1.10 – 2.60
Insolvency likely within 12 months	" 1.875	" 1.23	" 1.10

*Z and Z' utilize different coefficients and substitute book value of equity for market value of equity.

ENDNOTE

Since its founding in 1986, The Scotland Group, Inc. has worked on over 100 cases, in 30 industries in both domestic and international, public and private companies. Its CEO, David L. Auchterlonie, is a certified turnaround professional (CTP), the highest designation possible in the turnaround management profession. The author may be reached at (949) 673-7750.

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