Lessons Learned from Research on Restructured Firms

by David L. Auchterlonie

Perhaps the most important determinant of successful restructuring is the timeliness with which companies, lenders, workout departments, and private equity portfolio managers react. The longer a financially challenged company operates in distress, the more likely that options available to restructure the firm will be eliminated. Furthermore, chances of bankruptcy in these cases increase substantially. This article presents early warning signs of distress, the stages of restructuring, and common characteristics of a successful turnaround situation.

Workout departments across the U.S. are littered with the flotsam of 2001. According to the American Bankruptcy Institute, business bankruptcies for public companies increased 46% during that year. Pecuniary equity sponsors are returning uncommitted capital to their limited partners and spending more time with distressed private company portfolio companies. Turnaround practitioners from coast to coast face significant increases in the number of cases they manage. While a transfixed media focuses on current high-profile cases involving failures of accounting transparency, there is nothing particularly new in the root causes of financial distress for companies.

Early Warning Signs

Business owners, commercial bankers, equity sponsors, and shareholders never expect *their* company to become financially distressed. In reality, every company has a life cycle, and, at some point, crisis or financial distress should be expected. Recognizing early warning signals of distress increases the likelihood that immediate corrective action can

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be implemented when there is a crisis.

Rapid growth. Rapid revenue growth indicates that pressure is put on a firm's infrastructure. Already too thin management and control systems cannot operate effectively. Ultimately, customer relations is affected, pricing pressures increase, and margins retreat.

Deal structures. Acquisition transactions completed over the past several years frequently have included debt-to-equity ratios of three to four times. Despite warnings from such organizations as RMA, much of the nation remained in denial about the possibility of a downturn. When it did materialize, broken covenants created loan defaults. A fully leveraged new transaction leaves little opportunity for missteps in operating performance; said another way, less leverage provides more opportunity to finance the company if an unforeseen event occurs.

Systems conversions. Enterprise resource planning systems, with fully integrated accounting and operating modules, can create efficiencies in most businesses. Unfortunately, virtually none of the conversions go smoothly. A well-thought-out implementation and training plan, together with a backup contingency plan when systems "don't quite work," should always be prepared as part of a formal systems plan. Entire functional units of a business, such as shipping and billing, can be seriously interrupted without adequate system migration plans.

Inadequate understanding of customer and product line profitability. Margin improvement cannot be effective without a full understanding of the direct contribution margin resulting from customer and product line sales. Frequently, this analysis results in

rationalization of stock-keeping units, reduction of unneeded inventory, and lower costs to service customers.

Ineffective management. Autocratic CEOs, demanding principals from equity sponsors, egocentric CFOs, and sales managers who defy accountability represent clear signs of danger for any organization. Ineffective use of incentive compensation, bloated organization structures, and management by committee also are death knells for many distressed organizations.

Overexpansion/aggressive acquisition strategy. New product launches not accompanied by in-depth customer surveys spell trouble. Acquisition strategies and roll-up strategies without sufficient financing capacity and infrastructure will likely result in unexpected problems following acquisition. Lengthy and costly post-acquisition integration stress frequently results from lack of adequate due diligence to detect challenges in integrating the acquired entity into existing operations.

Low-margin distribution channels. The variety of distribution channels available for the company's products and services gives insight into the opportunities to grow the business. In many instances, distribution into lower-margin channels does not generate sufficient cash flow to cover the fixed and variable expenses. Examining opportunities to expand distribution channels into higher-margin activities creates improvement in EBITDA results.

Z-Score analysis. Edward I. Altman, Ph.D., a financial economist and professor at New York University's Stearn School of Business, developed the Z-Score in 1968. Altman's model is useful for periodically taking a snapshot of a portfolio company's likelihood of bankruptcy.[1]

Lack of financial and operating controls. Is the company operating without adequate finan-

cial or operating controls? These controls can include the timeliness of such reports as well as the quality of information produced. Management decisions based on old or inaccurate information can certainly have the result of heading the company into the wrong direction.

Precarious customer base. The business relies on a few big customers or large relationships for its sales. If two large, big-box retailer customers represent 60% of a distributor's business, the company is obviously vulnerable. The loss of just one customer could put the company in financial distress.

Family versus business matters. Family businesses create very challenging environments. Decisions frequently are based on emotions rather than sound business judgment, and sibling rivalry can ruin a privately held company. It's particularly difficult to decide which relatives should run the business and then create a sound succession plan to pass the management process from the founder to the children. Divorce and nepotism also haunt family businesses, requiring vigilance by equity sponsors and lenders.

Delay in keeping pace with market/technology changes. Changes in the marketplace have bypassed the company, leaving it with sagging sales and lost market share. Some companies' equipment and their products and services have become technologically obsolete; other problems lie in understanding market shifts, in which new products or services miss customer demand cycles.

"Fixing" Companies in Workout

Once a company has been assigned to the workout department of a financial institution, substantial unplanned demands are placed on the company, including weekly cash flow forecasts, collateral audits, independent valuations, pressure from customers and trade creditors, and demands for more communication to the firm's employees. More than at any other time, companies need professional help at this stage.

Professional turnaround practitioners, called Certified Turnaround Professionals (CTPs), follow five generally accepted stages to their work:

1. Situation analysis.
2. Management evaluation.
3. Emergency action.
4. Business restructuring.
5. Return to normal.

Situation analysis stage. The objectives in this stage are to analyze and verify that the business is indeed viable, to identify the type of turnaround strategy most appropriate to the situation, and to develop a preliminary action plan for implementing the chosen turnaround strategy.

A CTP will examine cash flow by product line during this phase to ensure that the core business is central to the turnaround plan, as well as the organization's strengths and weaknesses, competitive posture, cost structure, financing agreements, and business plans.

Management evaluation stage. Without an effective management team, a turnaround professional's efforts will not succeed. Accordingly, a CTP's first task is to evaluate existing management, including the CEO, CFO, chief sales and marketing officer, and chief technical or operating officer. Changes to key management positions should be made early on to ensure that the best management team available leads the turnaround effort.

Emergency action stage, or "the crisis period." The objective is to generate positive cash flow consistently and as quickly as possible, taking whatever actions are necessary to enable the organization to survive. This also is the time when a CTP may take a first-hand role in managing the situation, with a mission to establish a professionally managed organization and imprint a culture of timeliness, thoroughness, fairness, order, and discipline. This requires examining each functional area, including organization structure and financial reporting practices, as well as identifying efficient and nonefficient assets. The CTP also establishes a direct dialogue with the company's key financial institutions, customers, and significant suppliers during this period.

Business restructuring stage. The objectives during this period are to enhance profitability through increased operating efficiency and to restructure the business for increased profitability and return on assets and equity. The focus is on customer expectations and how each part of the company can satisfy customer needs. Unprofitable business segments and product lines are sold or shut down. Daily and weekly operating and financial performance measures are enacted. Organizational goals are established

and tied to customer satisfaction and financial results.

Return-to-normal stage. During this period, the objectives are to:

1. Establish ongoing mechanisms that emphasize profitability, return on equity, and the enhancement of economic value-added operating results.
2. Seek out opportunities for profitable growth.
3. Build the competitive strengths the business will need to fully exploit such opportunities.

This also is the time to explore new markets, examine synergistic business situations, consider strategic alliances, and seek strategic leverage to grow the business on more solid footing.

Common Characteristics of a Successful Turnaround

Changed culture. Organizations facing distress are unwilling to change existing practices. In addition, communications are stilted, and the organization is generally dysfunctional. A successful turnaround creates an environment of free-flowing communication as a result of embedded processes, improved reporting, and profit-focused accountability.

Refocus to cash flow enhancement. Cash flow enhancement is the mantra in restructured organizations. Weekly cash flow measures, investment in inventories, collections of receivables, and expenses of supporting customers all are institutionalized in restructured companies. Employee training programs are enhanced to focus on ROI and ROE. Incentive compensation is used liberally to trumpet successes when achieving preestablished goals.

Disciplined management. Implementing the strategic plan, including the annual plan, becomes the most important component of management's actions. Core competencies are well understood, and market share and competitive analyses allow the company to dominate its position. Improved communication among management team members results because common goals become clearly established.

Revitalized workforce. Employees surviving a restructuring are married to the organization. They believe in the products or services offered to customers and have a clear sense of the direction of the organization. Cross-functional teams provide improved understanding of different areas. And effective compensation and award systems create meaningful incentives.

Customer/market focus. Ultimately, a successful restructured organization turns its entire focus to meeting customer needs on a profitable basis. In doing so, products and services designed to meet customer expectations are planned through active research and development activities. Competitive analysis provides important diagnostic and marketing information concerning the competitive landscape. New products and services are successfully introduced as a result of better customer communication and market intelligence. ❐

Notes

1 For more information concerning the Z-Score, refer to "A Paean to the Z-Score and Its Commercial Bankruptcy Prediction," *The Journal of Lending & Credit Risk Management*, September 1997, or refer to www.scotlandgroup.com and compute the Z-Score for the portfolio company in question.

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