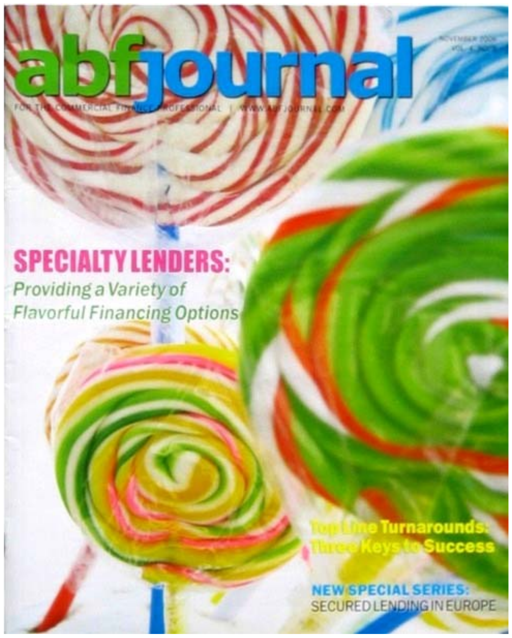

Recover & Preserve Value: Working Successfully With Turnaround Professionals

By John M. Collard

Turnaround Corner

Part 1 of 2

The turnaround of a business in financial distress involves managing the business and its problems. The process is time consuming and requires a special set of skills. The problems of the business are often compounded by owners or management who are facing financial distress for the first time and who are reticent to change. This is where a turnaround specialist brings his art to the process.

The identity of the client must be clear. The client's identity may appear clear at first glance, but it can quickly become blurred. For example, the owner of a closely held business may be as concerned about personal guarantees as about the survival of the business. In addition, if the lender has referred the specialist, the specialist must make it clear to all parties whether the lender or the business is the client.

Turnaround specialists generally are either interim managers or consultants. Interim managers will replace the CEO, take the decision-making reins of a troubled business, and guide it through its troubled waters, hopefully to safety. Turnaround consultants advise existing management without taking an operating role within the company. Although some specialists are willing to act as either an interim manager or a consultant, most prefer to act as one or the other.

A troubled business may also need the help of an experienced general manager or an expert in a particular aspect of the business. A troubled business often has a unique problem that requires an industry-knowledgeable expert rather than a experienced general manager. Naturally, this determination depends upon the particular company, industry, and problems involved. Keep in mind, however, that industry knowledge is not the same as turnaround management knowledge. A skilled turnaround specialist can often revive a company using his/her turnaround talents despite initial unfamiliarity with the technical aspects of the business.

Many turnaround specialists also concentrate on varying stages of business decline. While some practitioners work with clients in or on the edge of bankruptcy, others concentrate on only those in an early stage of decline.

Is A Turnaround Specialist Needed?

Before this question can be answered, it is important to understand why businesses fail. The answer is usually mismanagement. Some of the many internal and external factors controlled by management include:

- ***Autocratic management*** resulting in overextended management, unclear lines of authority.
- ***Ineffective communications***, unnecessary meetings, etc.
- ***Neglect of human resources*** evidenced by excessive turnover rates.
- ***Inefficient compensation and incentive programs.***
- ***Company goals that are not understood or achieved.***
- ***Deteriorating business*** from established clients, indicating strategies are outdated.
- ***Inadequate analysis of markets and strategies.***
- ***Lack of timely and accurate financial information.***
- ***History of failed expansion plans.***
- ***Uncontrolled or mismanaged growth.***

Management is often prone to blame the misfortunes of the business on external factors ostensibly beyond their control rather than to be held accountable and correct the situation. Some of these external factors include:

- **General economy**
- **Unfavorable legislation**
- **Interest rate fluctuations**
- **Labor unrest**
- **Labor cost increases**
- **Competition**
- **Litigation**
- **Market decline**
- **Raw material cost increases**

WARNING SIGNS: How Do You Diagnose Trouble?

What are the warning signs of a business heading toward trouble? This is one of the most frequently asked questions of turnaround specialists. Trouble comes from a variety of causes. The obvious signals are rarely the root cause of the problem. Losing money, for example, is not the problem, but the result of other problems.

The warning signs listed below are not all-inclusive, but may provide some insight as to why the company is facing difficulty. Signs connected with operational performance include:

- **Decrease in profit**
- **Lack of short- and long-term planning and forecasting**
- **Quality control problems - returned goods, complaints**
- **Late or slow delivery**
- **Increase in fixed costs relative to revenues**
- **Management and employee turnover**
- **General employee dissatisfaction and performance**
- **Employee layoffs**
- **Declining revenues per employee**
- **Trade credit difficulties and restrictions**
- **Failure to take purchase and other cash discounts**
- **Delay returning telephone calls**
- **Delay submitting financial to banks, lenders, suppliers**
- **Board of Directors resignations**
- **Auditor resignations or turnover**
- **Failure of board of directors to diligently exercise its oversight function**
- **Return "retired" founder to visible management position**
- **Failure to adapt to new technologies**

Signs relating to a company's financial performance include:

- **Decrease in profit**
- **Decrease in sales**
- **Continued failure to meet bank loan covenants**
- **Decrease in available cash**

Signs associated with poor asset utilization include:

- **Worsening cash position - reduced working capital**
- **Decrease in quick asset ratio**
- **Increase in the debt to equity ratio**
- **Dwindling capital base**
- **Declining asset turnover rate**
- **Declining accounts receivable turnover rate**
- **Deteriorating account receivable aging**
- **Declining inventory turnover rate**
- **Deteriorating account payable aging**
- **Creeping loan balances**
- **Reduced R&D expenditures**
- **Changing accounting principles**
- **Financing purchase of fixed assets with working capital**
- **Overpaying for assets or business units**
- **Acquisitions of or expansion into non-core businesses or which cut into or compete with the core business**

These signs are symptoms, not the problem. The signs are simply the evidence that a problem exists, and it is the problem rather than the symptom that must be identified and remedied.

Several Formulas Exist to Predict Failure.

One widely known formula is the Z-Score, developed by Professor Edward Altman of New York University. By weighing various financial ratios, the Z-Score attempts to predict whether a manufacturing company is a bankruptcy candidate.

The formula: $\mathbf{Z = 1.2A + 1.4B + 3.3C + 0.6D + 1.0E}$

Where:

A = Working Capital / Total Assets

B = Retained Earnings / Total Assets

C = Earning Before Interest and Taxes / Total Assets

D = Market Value of Equity* / Book Value of Total Debt

E = Sales / Total Assets

(*)When the company is not publicly traded, book value of equity should be substituted for market value.

Resulting scores are interpreted to indicate the following:

√ **Less than** 1.8 — The company has a high probability for bankruptcy within the next two years.

√ **Between** 1.8 & 3.0 — The gray zone where the trend is really the most important criteria.

√ **Greater than** 3.0 — The company has a low probability for bankruptcy.

A second statistical method developed by Jarrod Wilcox, former assistant professor at MIT's Sloan School of Business, is known as the Gambler's Ruin Prediction of Bankruptcy. This formula, designed to predict possible bankruptcy for manufacturing and retail companies up to five years in advance, is as follows:

Liquidation Value = Assets - Liabilities

Where:

Assets = 100% of cash and marketable securities plus 70% of accounts receivable, inventory, and prepaid expenses plus 50% of remaining assets.

Change in Liquidation Value from previous year = Earnings before special items minus 100% of dividends minus 50% of year's capital expenditures and depreciation minus 30% of increase in inventory and accounts receivable since prior year.

If these computations indicate negative amounts, the company is considered a candidate for bankruptcy.

Companies Susceptible to Trouble

Given the market forces of capitalism, all businesses are as vulnerable to trouble as they are to the lure of success. We live in a world of wildly changing technologies. Even with these changes, a business that is managed properly will continue to prosper. However, some industries are more susceptible to trouble than others due to various factors and characteristics.

The fortunes of companies in ***cyclical industries*** often depend upon forces outside their control such as commodity prices or weather conditions. Those most likely to withstand the effects of these forces are the ones that learn to adapt. They either sufficiently diversify without losing sight of their primary business or are able to control fixed costs in unstable conditions. The ability to adapt is key.

Companies in ***newly deregulated industries*** face having to learn to survive in a competitive environment without the legal protections previously enjoyed. Deregulation is generally accompanied by an anticipated shakeout of the weakest businesses as competitive forces take hold in the marketplace.

As the United States has evolved from a primarily manufacturing driven economy to an economy increasingly driven by ***service-oriented industries****,* management must recognize that its most irreplaceable assets are employees. Managing human resources is more important than ever.

Companies lacking a proprietary product*,* - or "me-too" companies - are subject to attack from every direction. Examples of these companies are retail businesses and non-licensed service sector businesses. They face low entry barriers both with respect to capital and expertise and a multitude of competitors.

Many entrepreneurial companies and start-ups are ***single-product and single-customer companies.*** In order to succeed, these companies usually must develop new products or diversify to compete and satisfy customers. Few are able to maintain their start-up success, but instead struggle to compete with existing competition and new market entrants. Reaching maturity takes years during which the company is vulnerable.

Rapidly growing companies are often driven by entrepreneurial zeal and overwhelming emphasis on sales. Often, inadequate attention is given to the effects of growth on the balance sheet. With huge sales increases and significant investments into R&D, these companies suddenly find themselves in a situation where the balance sheet simply cannot support the growth.

Highly leveraged companies have so many factors that must converge to be successful that they are often most susceptible to the external uncontrollable causes of business failure, such as interest rate fluctuations or an increase of raw material costs.

Closely held businesses and family owned businesses*,* by their nature, select leadership based not upon managerial talent but by virtue of family or close personal relationships with the shareholders. More than in other businesses, owner/managers link their personal psyche to that of their business. To the owner/managers, business failure is often perceived as a personal failure. Owner/managers often believe that they are irreplaceable or are afraid to admit that they are not. They want to maintain control, and consequently, they fail to either develop a management team or a plan for transition of management. These owner/managers are reluctant to acknowledge early warning signs of failure and are also apt to ignore them.

Perhaps ***declining industries*** face the most difficult task of all. Declining industries are those in which total industry-wide unit shipments are declining. Maintaining market share involves shrinking. Maintaining volume involves increasing market share (i.e., taking business from competitors). Management, which refuses to admit that the industry is declining or bets its future on the industry recovering, is the most prone to failure.

Approximately 70% of ***entrepreneurs and start-ups*** fail within two years. Entrepreneurs do not necessarily come from managerial backgrounds. They have visions of what the future will look like before the rest of us know to invent the better mouse trap. Their *modus operandi* is to capitalize on their head start as a way to convert their vision to a profitable reality. The same skills that keep an entrepreneur focused on an idea, regardless of obstacles, can make him oblivious to the competition on his heels or to new changes in the market. Ultimately, the market does catch up, forcing the entrepreneur to compete in a mature industry rather than in an emerging industry. As entrepreneurs survive the transition to professional management and new technologies gain a stronghold on the economy, emerging industries are born.

Hiring A Turnaround Specialist

Before seeking a turnaround specialist, a business should attempt to understand its desires and needs and it should be willing to face the reality of very difficult issues. With statistics generally pointing to mismanagement at the root of most crises, the business should be aware that the turnaround specialist will perform a quick study of management capability. Management must be committed to participate in the recovery, agree that the turnaround specialist is the catalyst to the recovery, and undertake to learn as much as possible so that it can better manage the business at the conclusion of the turnaround engagement.

Thus, before calling a turnaround specialist, management should ask itself some hard questions:

- **Can a turnaround be realistically achieved?**
- **Is management aware that a true turnaround can take years to accomplish?**
- **Have business issues been isolated from personal issues? Or, is the primary goal of hiring the specialist to protect the owner from personal guarantees and preserve personally owned assets?**
- **What can be reasonable and realistically expected from the turnaround specialist?**
- **Is management willing to admit the business' problems are, in all likelihood, the result of mismanagement?**
- **Is management willing to become, if necessary, the student rather than the teacher or the follower rather than the leader?**
- **If asked to give up the controls of the business, is management willing to do so?**
- **Is management willing to face its own shortcomings and to face facts that may reflect on its ability?**
- **Since the turnaround specialist is often a temporary fix, is management willing to change?**
- **Can management learn to function in a highly controlled environment, subject to being monitored by outsiders?**
- **Is management willing to accept business' failure since some are simply unavoidable and not savable?**
- **Is management willing to agree to a turnaround specialist's engagement if the only realistic expectation is to maximize liquidation value even if the ultimate result is the failure of the business?**
- **Is management willing to sell control and become both a minority shareholder and an employee of a new board of directors if necessary to attract the capital to preserve the company?**
- **Is management, in the case of smaller businesses particularly, willing to face stigma of bankruptcy?**

How To Select a Turnaround Specialist

Owners should be cautious and deliberate in selecting a turnaround specialist. Retaining a turnaround specialist has been analogized to having a heart transplant, an experience few would undertake without much trepidation. But just as heart transplants are necessary to save the life of the patient, a corporate turnaround is very often what is needed to keep a business alive.

Interviews and Background Checks

Owners should do their homework before interviewing any turnaround specialist. Resumes and references should be requested and checked in advance. Owners should not be misled by professional affiliations and should avoid hiring unneeded skills. Beware of an unemployed CEO or CFO masquerading as a turnaround specialist. Simply having a background as a CEO does not mean that the candidate will possess the needed skills to be a good turnaround specialist. Lawyers, accountants, bankers, and financial advisors should be consulted for their opinions and advice.

Several specialists should be interviewed. Despite their hopes, owners should neither expect miracles nor be misled by unrealistic promises or guarantees of success. What the turnaround specialist offers should be weighed against what is realistically achievable.

Be introspective, as the questions above suggest. But when the turnaround specialist arrives, answer his questions, help him find his answers, and above all, listen. Do not forget that owners and management must work together as a partner with the turnaround specialist. Existing management is a key resource for the turnaround specialist and should adopt an attitude that it wants to learn as much as possible so that it will have the skills necessary to run the business when the turnaround specialist's engagement has been completed.

Time Commitment of the Turnaround Team

Ask the turnaround specialist about his/her work schedule. Meet the entire turnaround team, particularly those who will be on the company premises. Obtain commitments regarding the turnaround specialist's personal involvement. Understand what functions he will perform and what will be delegated to his staff. Ask about the interplay between the company's management, the company's staff, and the turnaround team.

Select an Individual

The personal chemistry between the turnaround team and management is critical to the success of the recovery. Thus, select a person, not a firm or a reputation. A turnaround is a very personal and highly sensitive operation. Management should select the specialist it thinks can do the best job, not a firm because it has a good reputation. The reputation will not turn around the company; an individual might.

Credibility

Learn about the turnaround specialist's relationship with your lender, other potential lenders, trade creditors, and alternate suppliers. Make sure the specialist brings credibility. Companies in trouble often need access to products and funds. One of the resources the turnaround specialist brings to the engagement is credibility to lenders, and consequently, enhanced access to credit. A troubled business often needs more money than its existing lender will supply, and therefore, management assumes a successful turnaround will involve a new lender. This logic, however, often ignores the relationship between the company's operating problems and its lender. It is unreasonable to anticipate that a new lender will be more lenient. In fact, a new lender will likely extract stricter covenants and restrictions, charge significantly higher fees because of the risk of going into a troubled situation, and monitor the loan much more closely. Therefore, the "old" bank may be the company's best source of new money if credibility can be re-established.

Obtain a Written Proposal

Always obtain a written proposal from the turnaround specialist. That proposal should address the turnaround specialist's initial findings, expectations from you and your staff, professional fees, anticipated use of the company's staff, a time line overview, who will be assigned to the engagement, how much time the turnaround specialist expects to commit to the engagement, whether the turnaround specialist will be on hand to implement the plan, at what point the turnaround specialist would expect to withdraw from the engagement, the complete fee structure, and how the turnaround specialist will assist in whatever management changes are necessary. Finally, insist upon and enter a written engagement agreement prior to engagement.

Regular Written Reports

Ask for regular written reports from the specialist. These reports should be concise and timely. They will force the turnaround specialist to organize his thoughts, get to the essence of what has happened in the reporting period, not require a significant amount of his time, and make it clear that he works for the company.

Involvement in Company's Operations

Expect the turnaround specialist to involve the company's staff in the daily operations of the business. Seek from the company's staff an evaluation of the performance of the turnaround specialist. Although the initial engagement of a turnaround specialist can be unsettling, management and staff should be made to understand that their jobs are linked to the turnaround effort. Share those evaluations with the turnaround specialist.

Confidentiality and Accessibility

Most importantly, demand and expect both confidentiality from and accessibility to the turnaround specialist. Though the turnaround specialist may be brutally honest with the client, he must present the client in the best light possible to others. Given precarious circumstances, the company must have as much access as it needs to its turnaround specialist. **abfj**

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