Tips to Turn Around a Distressed Company: A Nuts and Bolts Approach

Outline of Speech to Georgia Bar Association

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1. Recognize the Cash Situation is Much Worse than Reported, and the Company Did Not Just Become Distressed.

2. Understand that Senior Management Does Not Have the Turnaround Skills to Fix the Problems and May Resist Outside Help.

3. Immediately Engage a Turnaround Firm with an Operational, Financial and Strategic Skill Set.

4. Manage for Cash, not Earnings.

5. Make Working Capital a Major Focus.

6. Understand a Lender’s Perspective.

7. Involve All Employees in Developing and Implementing the Action Plan.

8. Compress the Time Frame, and Don’t Slow Walk the Changes.

9. Continue to Develop and Refine Cash Generation Options.

10. Maintain Credibility at All Costs

Overview

What is a distressed company?

- A company that is facing a viability crisis can be said to be "distressed."
- A company that may not have recognized or acknowledged it may also be distressed.

What is a viability crisis?

- A company that can't generate the cash resources to support its future existence.
- Throughout their lives, most companies face viability challenges.

What are indicators of a distressed company?

- Deteriorating performance
- Continually missing earnings and cash targets
- Doctoring financial results
- "Excusing away" critical capital expenditures
- Experiencing day-to-day liquidity crisis
- Worsening net working capital
- Continually reducing balance sheet reserves

- The recurring problem in turning around distressed companies is that boards of directors (BOD) often postpone engaging a "turnaround" professional—with an operational, financial and strategic skill set—until the company is almost out of cash. At this stage, few options remain except to sell or liquidate the company. BOD's believe they are "selling out management" if they engage a turnaround professional. Yet not engaging a turnaround professional is a breach of the BOD's fiduciary responsibility.
- In order to implement significant changes in a very short time, the turnaround professional must **involve all employees,** especially the highly-skilled team members—both salaried and hourly. They are a key to implementing significant change within a short time.
- The turnaround strategy—not just financial engineering—must work for your company and in your industry and environment. There is no cookie-cutter solution, but there is a world of opportunities.
- **There is no such thing as a quick fix.** Since the financial results have probably been doctored for many quarters, the **situation may be much worse than advertised,** and the problems may be hidden.

01. Recognize the Cash Situation is Much Worse than Reported, and the Company Did Not Just Become Distressed

- Companies become distressed through:
    - Excessive leverage—especially coupled with an unpredictable revenue stream
    - Unsuitable Management Processes—given the company's leverage and market challenges
    - No strategy or Value Proposition to steer the company
    - Doctored financial results that have hidden the problems
- This is no time to accept excuses.
    - Please, no weather excuses.
    - If there is an industry downturn, management should have implemented the necessary changes.
    - Compensating controls for known risks should have been implemented.
    - Cash-losing operations should have been sold or closed.
    - Underperforming managers should have been replaced.
- Options available to turn around a distressed company diminish rapidly. If the BOD continues to postpone engaging a turnaround professional, a more radical fix—such as liquidation—may be required.

02. Understand That Senior Management Does Not Have the Turnaround Skills to Fix the Problems and May Resist Outside Help Once a Company Becomes Distressed

- Senior management:
  - Has not recognized—by taking appropriate action—the severity of the liquidity problem
  - Is probably not objective
  - Has lost credibility with the lenders
  - Has too much emotional ownership to take the necessary actions.

- Senior management should recognize that a turnaround firm could validate their strategy, thereby improving their credibility.

- Often, the employees labeled as “trouble makers” play a major role in turnaround companies because they are more interested in change than in maintaining the status quo.

- Lender fatigue, which occurs when lenders tire of dealing with senior managements’ paralysis, is a major issue. Lenders will stop listening to the management team, and the situation will deteriorate.

03. Immediately Engage a Turnaround Firm with an Operational, Financial and Strategic Skill Set

- Don’t assume industry experience is needed.
    - Usually, there is adequate industry experience within the distressed company.
    - Many times, industry professionals all have the same preconceived bias, or there is too much inbreeding.
    - What’s missing is a professional experienced in implementing significant change within a short time.

- Turnaround consulting skills are not interchangeable.
    - Financial engineers—cut expenses and reduce headcount but don’t have the skill set to rebuild the company. Bankruptcy work is one of their services—requiring a different skill set than rebuilding.
    - Operational professionals experienced with leveraged, cash-poor companies better understand where to reduce expenses so they won’t impair the company’s key capabilities.
    - Strategic CEO’s experienced with leveraged, cash-poor companies can eliminate cash burn as well as rebuild the company.

- Use care when selecting the turnaround firm.
    - Request a written proposal.
    - Meet the entire team, not just the partner. Hire professionals that will be on the engagement day to day, instead of a firm or a rainmaker.

- Choose consultants with experience operating distressed companies, not just consulting to them.
- Find on-site consultants who are team players and can **relate to all employees.** Turnaround professionals must work through the entire organization to implement an action plan.

04. Manage for Cash, not Earnings

What is Cash Flow?

- Cash flow for a period is the **change in** "adjusted book cash." It's what you can spend.
    - Start with bank cash and subtract all outstanding checks and add any deposits in transit.
    - Subtract **"excess payables"**—defined as all payables beyond the agreed-upon terms, which may be much different than the published payable terms.
    - Subtract any checks held—maybe in someone's drawer; if it's not included in outstanding checks.

- Eliminate the focus on earnings because it frequently eats cash. Examples are focusing on overhead absorption and achieving manufacturing efficiencies, both of which can artificially increase earnings but waste cash.

How to Monitor Cash Flow

- Develop both a 13-week cash forecast and a borrowing base forecast certificate (BBC).
    - Forecast collections individually for the top 30 customers.

    - Breakout each disbursement category on a separate line.
    - Forecast payables individually for the top 30 suppliers.

- Understand that cash meetings are not a financial department meeting. Cash meetings must include the CEO, the managers from sales and marketing, operations, collections, materials and product scheduling.

- Establish daily cash meetings to review the 13-week cash flow. Cash flow should be updated daily and start by **reconciling the changes** from the previous cash forecast. The 13-week cash forecast must be elevated to the most important function and must drive the operations.

05. Make Working Capital a Major Focus

- Working Capital is defined as accounts receivable (A/R), inventory and accounts payable (A/P).

- Working Capital Days should be computed for the entire **company—currently** and as of 6 and 12 months ago:

    - Working Capital Days (WCD) = A/R Days + Inventory Days – A/P Days
    - A/R Days = **(**A/R end of month balance/Last 12 months sales**)** times 365
    - Inventory Days = (Inventory end of month balance/Last 12 months Cost of Goods Sold) times 365
    - A/P Days = **(**A/P end of month balance/Last 12 months COGS Materials + COGS OH) times 365

- Working Capital Days should be computed for **each subsidiary** and **each product line.** You may hear: "Our financial system doesn't enable us to determine working capital by product line." Don't accept this answer. Management must compute WCD's for each major product line; calculation may require allocation assumptions.

05. Working Capital should be a Major Focus (continued)

Accounts Receivable

- Implement a disciplined collections approach to drive down DSO.
    - Ascertain that sales invoices are sent the day of or day after shipment.
    - Call major customers 3-days after they've received the invoice to ascertain that the documents are complete and correct.
    - Insist that Collections Managers prepare a detailed collections forecast (for top 30 customers) to coincide with the 13-week cash forecast.
    - Make Operations, Sales and Collections Representatives active participants to accelerate collections.

05. Working Capital should be a Major Focus (continued)

Inventory

- Examine and challenge the production scheduling assumptions for each major product line. In manufacturing companies, production scheduling can provide the biggest inventory reduction opportunity.

  - Focus on customer cycle time (elapsed time from customer order to shipment) rather than manufacturing efficiencies. Focusing on achieving manufacturing efficiency objectives normally results in excess inventories and a much longer cash cycle.
  - Challenge production scheduling assumptions, including lead times and safety stock levels. Typically, these assumptions reflect many years of unrealistic “cushions.”
  - Ascertain that the bill of materials (BOM) is correct for major product lines. Incorrect BOM’s may cause the wrong materials to be ordered and result in missed customer shipments (cash) and excess inventories.

Accounts Payable

- Immediately determine how much are **excess payables**, which should be viewed as additional debt.

- Insure the disbursements supervisor understands the cash available to pay suppliers for each of the 13-weeks.

- Minimize the use of bank wires.

- Don't "dodge" calls from suppliers. Return their calls promptly and promise only what you can do. Earn the suppliers' trust by doing what you say. A detailed 13-week cash forecast minimizes surprises.

06. Understand a Lender's Perspective

- Lender fatigue is a major issue and will rapidly become irreparable.

- Lender's decision is whether to support a turnaround or liquidate.

- Lender's Focus
    - Collateral—no/minimum deterioration in collateral value
    - Cash Burn Rate—adequate to implement the action plan
    - Liquidation value—orderly liquidation values
    - Multiple Exit Opportunities—continue to refine

Collateral

- Update the 13-week forecasted BBC weekly.

- Insure the CFO and operations management thoroughly review the forecasted BBC.

- Immediately update the lenders of significant changes. Again, no surprises.

Cash Burn Rate

- What is the burn rate, if left unaddressed? Each situation requires a different survival plan.
  - 1 month or less—survival is doubtful
  - 2-4 months—survival depends on implementing significant changes ASAP
  - 6-9 months—provides more time to take appropriate action

6.) Understand a Lender's Perspective. (continued)

Liquidation Estimate

- Provides a boundary for the lender and will be balanced against collateral preservation, cash burn rate and whether the changes can be implemented in the compressed time frame.

- Requires senior management to prepare a liquidation analysis to guide the viability of the proposed action plans.

Exit Options

- Be realistic about the likelihood of implementing the necessary changes within the required short time in order to successfully turn around the distressed company. This is no time for optimistic thinking.

- Develop multiple contingency plans. Don't assume anything. Murphy's Law loves distressed companies.

- Continually update and revise the exit options. Major change happens daily.

- Lenders may support a turnaround if:
  - The company is deemed viable.
  - Management demonstrates they will take the requisite drastic actions in the compressed time frame.
  - There is minimum risk of receiving less than the orderly liquidation value.

07. Involve All Employees in Developing and Implementing the Action Plan

- Be careful about the number of programs to be implemented. Make sure the **time** required to implement many small programs **is commensurate with the cash generated.** Don't peanut butter your efforts.

- Consider focusing on fewer programs that will generate much greater cash.

- Keep the sales force as well as all employees in the communication loop—since **all employees** are instrumental in maintaining the revenue base. When a company is in trouble, the tendency is for senior managers to become even more "closed lipped."

- Remember that hourly workers and administrative employees may have developed long-term relationships with customers and may be critical to the turnaround. Keeping information from these employees can be more damaging to maintaining the revenue stream than a competitor.

- Keep your customers and suppliers in the communication loop. If they hear bad news as well as good news directly from you, they are less likely to listen to the competitor's bad mouthing.

- Keep all employees informed and involved by:

    - Conducting **brief** daily departmental meetings to keep the staff involved and informed.

- Conducting CEO led monthly meetings, for as many of the organization's employees as is practical.
- Scheduling regular CEO meetings with hourly workers, a much-overlooked group, and not with an entourage.

08. Compress the Time Frame, and Don't Slow Walk the Changes

- Replace monthly and quarterly targets with daily and weekly targets to compress the period.

    - Shipments
    - Orders
    - Collections
    - Cash flow

- Hold the entire organization accountable for achieving daily and weekly targets, which could "add 2-3 additional days to each month." This will immediately speed up the company's sense of urgency.

    - Immediately set up regular early-morning meetings to establish that it's not business as usual. (Frequently, I set up 6:00 a.m. daily meetings.)
    - Include employees from throughout the organization in the daily meetings—senior management, mid management and the skilled workers.

- Conduct **brief** daily meetings to monitor the actuals versus the projections. Expect senior management to complain that they

don’t have time for these meetings—as “we need to run the business.”
    - Cash meetings
    - Collections meeting
    - Production-scheduling meetings (also addresses customer shipments and orders)

- Again, establish daily and weekly measurements—include all levels of the organizations and then continually evaluate the actual performance versus the forecast.

09. Continue to Develop and Refine Cash Generation Options

- What are some of the exit options?
    - Shrink geographic coverage
    - Reduce market segments served
    - Sell specific assets
    - Sell product lines
    - Sell business units
    - Sell entire company
    - Liquidate in an orderly fashion
    - Liquidate immediately
- The cash burn rate will determine which options to implement.

10. Maintain Credibility at All Costs.

- Promptly return phone calls to customers, suppliers and lenders. Frequently, management delays returning calls because they don’t have “complete information” or good news. Waiting for complete information or good news will exacerbate the tension.

- Update the 13-week cash forecast every day and the BBC at least weekly. Murphy’s Law loves distressed companies.

- Communicate both bad news and good news immediately. If the action plan assumed the “bad news,” make sure all employees understand that contingency plans have already been developed to neutralize the problem.

- Finally, humor is a great asset in this difficult situation.