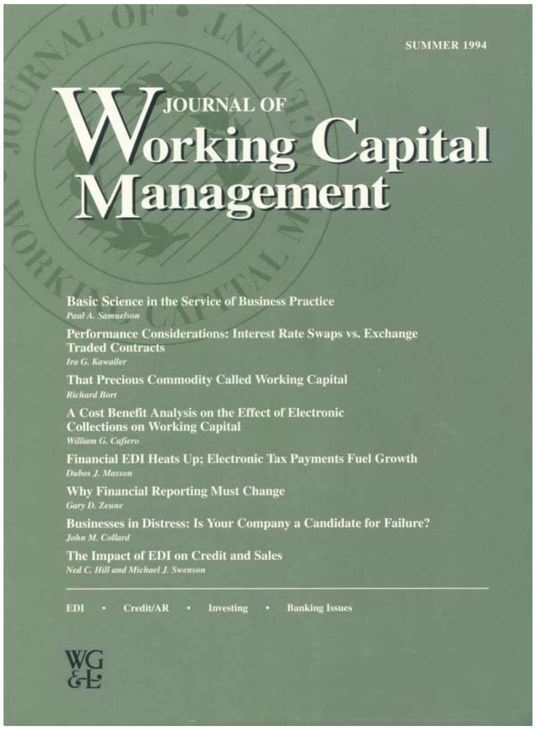

Businesses in Distress: Is Your Company a Candidate for Failure?

John M. Collard

This article is the first of a two-part series that seeks to help corporate financial managers to identify problems that may grow to threaten the very survival of their business. This part describes the early warning signs and the possible implications. Part 2, in the Winter issue, will describe a business turnaround process and how to deal with the critical issues of that process.

Part 1 of 2

Understanding why businesses fail can help the corporate financial manager recognize the ominous signs that portend trouble. Roughly 80 percent or more of business failures are traceable to internal or management controlled factors. These factors are many, including:

- *Autocratic management* evidenced by a reluctance to delegate authority or train new management. When managers continue to do the work that should be done by others, management becomes over extended. The problem is further compounded because often this situation produces unclear lines of authority.
- *Ineffective communications* between management and employees. Unnecessary or ineffective meetings, management information or interdepartmental coordination can destroy a business as it grows.
- *Neglect of human resources* indicated by excessive turnover rates. Turnover is a sign of serious problems; ignoring these problems results in low morale, lost wages, lack of production, and lost business.
- *Inefficient compensation and incentive programs* yielding unsatisfactory results. While it seems logical to reward for successful job performance, many companies unwittingly reward employee performance far different from that outlined in the job description.
- *Company goals not achieved.* Failure to meet goals often means goals are not clearly understood. The problems can also indicate failure to get all stakeholders to "buy in."
- *Deteriorating business* from established clients and new prospects. When long-term clients reduce their amount of business, this usually means the company is not meeting the customers' needs. Failure to secure new business is often a sign that strategies are outdated, and management is out of touch with the marketplace.
- *Inadequate analysis of markets and strategies.* Disciplined analysis is one business strategy that is often overlooked. A company whose products or services are developed before market needs are reviewed often must create their own demand to survive. This will cost a business several times more than a product or service that meets an existing demand.
- *Lack of timely financial/ information.* Financial and management reports that are late or contain irrelevant or inaccurate information hamper management's ability to understand its true financial performance. many businesses are managed on profit and loss performance rather than cash flow.
- *History of failed expansion plans.* Expansion plan setbacks not only drain a lousiness' cash, time, and morale, but also create reluctance to embark on future growth and expansion plans. Expansion efforts often fail due to lack of cash, management expertise, or thorough market analysis.
- *Uncontrolled or mismanaged growth.* Many businesses focus solely on one piece of the business (e.g., sales growth, operations, or supporting infrastructure) and neglect the other aspects. As a result, the business functions do not support each other, which severely impedes the firm's ability to support growth.

On the other hand, management may blame the business' misfortunes on external factors that management believes to be beyond its control, such as:

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

Instead, management must be realistic, be held accountable, and correct the situation. This is not to say that management is inept; but to survive, management must maintain a constant vigil over its operations and its objectives. Capitalism breeds both success and failure. Darwin is alive and well in the marketplace: only the fittest survive.

COMPANIES SUSCEPTIBLE to TROUBLE

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 properly managed business will continue to prosper. However, some industries are more susceptible to trouble than others.

The fortunes of companies in ***cyclical industries*** often depend upon uncontrollable external forces such as commodity prices or weather conditions. Those most likely to withstand the effects of these forces are those that either diversify without losing sight of their objectives, or that are able to control fixed costs in the face of unstable conditions. The ability to adapt is critical.

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

As the U.S. has evolved from a primarily manufacturing driven economy to increasingly ***service oriented industries***, management must recognize that its most irreplaceable assets walk out the door every night. Managing human resources is more important than ever.

Companies lacking a proprietary product, or "me too" companies, are subject to attack from every direction. These companies, such as retail businesses and non-licensed service sector businesses, generally face low entry barriers with respect to both capital and expertise.

Many entrepreneurial companies and start ups are limited to a single product or a passing fad. To ultimately succeed, ***single product and single customer companies*** usually must develop new products or diversify to protect themselves from powerful competitors, customers. and changing currents. Few are able to maintain their start up success as they struggle to compete. Reaching maturity takes years during which a company is vulnerable.

Rapidly growing companies often are driven bv entrepreneurial zeal and by an overwhelming emphasis on sales growth, while inadequate attention is given to the effects of growth on the balance sheet. These companies suddenly find themselves in a situation where the balance sheet simply cannot support the growth.

Highly leveraged businesses 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 in raw material costs.

Closely-held and family-owned businesses, bv their nature, select leadership based not on managerial ability 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. Owner/managers often believe that they are irreplaceable or are afraid to admit it. They want to maintain control ad infinitum, "'ailing to either develop a management team or a plan for transition of management. Owner/managers are reluctant to acknowledge the early warning signs of failure and are also apt to ignore them.

Perhaps ***declining industries*** face the most challenging task of all in preventing failure. Declining industries are those in which total industry wide unit shipments are declining. Maintaining market share involves taking business from competitors. Management that refuses to admit that the industry is declining or bets its future on industry recovery, is the most prone to failure.

Entrepreneuria1 hazards. Approximately 70 percent of entrepreneurs and start-ups fail within two years. Entrepreneurs do not necessarily have managerial abilities. 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 catches up, forcing them 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.

HOW TO DIAGNOSE TROUBLE

What are the warning indicators of a business heading toward trouble? Trouble can come from a variety of circumstances. The obvious signals arc rarely the root cause of the problem. Losing money; for example, is not the problem; it is the result of other problems.

The list of warning indicators below is by no means all inclusive, but it may provide both a barometer and some insight as to why the company is facing difficulty: They include

- Decrease in profit margins:
- Decrease in sales;
- Continued failure to meet bank loan covenants: and
- Decrease in available cash.

Indicators connected with a company's operational performance include:

- Lack of both short and long term planning and forecasting;
- Quality control problems, such as increased returned goods and customer 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 in returning telephone calls;
- Delay in submitting financial statements to banks, lenders, and suppliers;
- Board of Directors resignations;
- Board of Directors failure to diligently exercise its oversight function;
- Return of the "retired" founder to a visible management position; and
- Failure to adapt to new technologies.

Symptoms associated with a business' poor utilization of assets 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 the purchase of fixed assets out of working capital;
- Overpaying for assets or business units; and
- Acquisitions of, or expansion into, non core related businesses or into businesses which cut into or compete with the core business.

These are merely indicators and not the problems. They are simply the evidence that a problem exists; 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:

$$Z = 1.2A + 1.4B + 3.3C + 0.6D + 1.0E$$

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.

The 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 the 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, a 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 both manufacturing and retail companies up to five years in advance, is as follows:

$$\text{Liquidation Value} = \text{Assets} - \text{Liabilities}$$

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 the year's capital expenditures and depreciation minus 30% of increase in inventories and accounts receivable since the prior year.

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

MAKING a COMMITMENT to CHANGE

Management must attempt to understand its business needs, and it should be willing to face some highly difficult issues. With statistics generally pointing to mismanagement at the root of most crises, management should adopt a mindset that it wants to participate in the recovery, that it may need the help of a turnaround specialist to be the catalyst to the recovery, and that it wants to learn as much as possible so that it can better manage the business on the other side of the turnaround engagement. Therefore, 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?
- What can be reasonable and realistically expected from the turnaround specialist?
- Have business issues been isolated from personal issues? Or, is the primary goal of hiring the turnaround specialist to protect the owner from personal guarantees and preserve personally owned assets?
- Is management willing to admit that 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 bv outsiders?
- Is management willing to accept the business' failure since some are simply unavoidable and not salvageable?
- Is management willing to agree to a turnaround specialist's engagement if the only realistic expectation is to maximize liquidation value?
- 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 needed to preserve the company?
- Is management, particularly in the case of a smaller business, willing to face the stigma of bankruptcy?

THE RECOVERY PROCESS

The process of recovery, when using a turnaround specialist, involves several stages.

Fact finding. The turnaround specialist must learn as much as possible as quickly as possible about the present circumstances of the company.

Analysis of the facts. The turnaround specialist should prepare an assessment of the current state of the company.

Preparation of a business plan outlining and suggesting possible courses of action. The turnaround specialist will seek the input of the company's management to determine which of several alternative courses of action should be undertaken.

Implementation of the business plan. Once the course of action has been chosen, the turnaround specialist should be involved in implementing the plan, either as an interim manager or as a consultant to management. This is the time a specialist begins to build the team of players both inside the company and from outside resources.

Monitor the business plan. The turnaround specialist should keep vigil over the plan, analyzing variances to determine their causes, and the validity of the underlying assumptions.

Stabilization and transition. Assuming that liquidation is not the cornerstone of the business plan, the turnaround specialist should remain involved in the engagement until the business has achieved stabilization and to assist the business in a transition of management if necessary.

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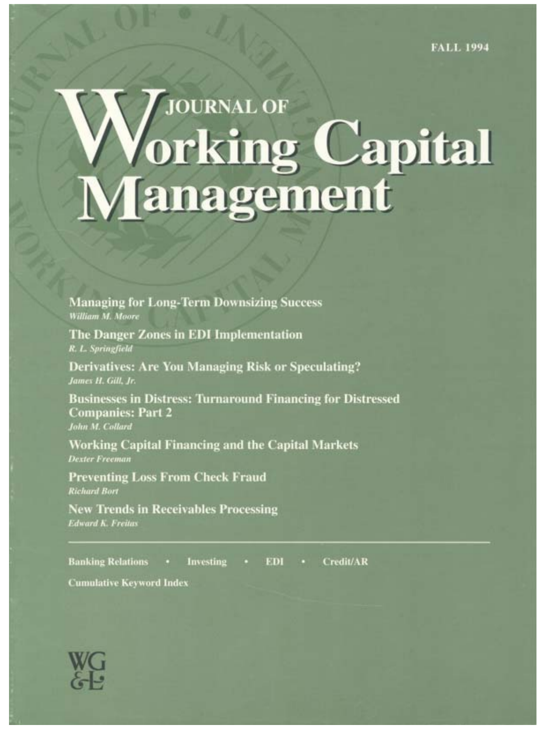
Businesses in Distress:
Turnaround Financing for Distressed Companies

John M. Collard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This is Part 2 of a two part series on Businesses in Distress. In Part 1, the author discussed the ominous signs of business distress and steps corporate management must take to avoid a business failure. This part discusses financing sources available to companies that recognize their problems and are resolving them. It also discusses how a turnaround specialist can assist management in restoring a company's financial health. This article is excerpted and adapted with permission from the Turnaround Management Association's 1993 Directory of Members and Services, written by John M. Collard.

Part 2 of 2

The owner or manager of a distressed business typically believes that raising more money will solve the company's financial problems. However, management must recognize that a shortage of capital is often only a symptom; it usually is not the primary problem. Although additional dollars are necessary to implement needed changes, a successful turnaround must first resolve the problems that produced the cash crisis.

FINANCING STRATEGIES

Financing is an integral part of a reorganization plan. An effective financing plan will stabilize the company's cash position and provide the needed capital to enable the business to again be profitable. Financing also will restructure the balance sheet to support the company in the future.

Financing strategies differ depending on the liquidity and viability of the distressed business. The initial task is to maximize liquidity and provide enough time to evaluate the lousiness' viability. In addition, management must cut costs and try to renegotiate existing financing arrangements to terms the company can live with during the turnaround.

A financing plan can include a Recapitalization, which involves changing the relationships among financial stakeholders through debt and equity conversions, exchange offers, stock rights offerings, and adding new financial stakeholders. Obviously, the more severe the financial crisis, the more difficult it is to work out an arrangement with trade creditors, lenders, and equity holders. It also makes it harder to attract new stakeholders.

TURNAROUND FINANCING

Turnaround financing specialists provide a number of financial resources and expertise on which to draw. They can work with all of a distressed firm's stakeholders, including lenders, equity investors, and purchasers of securities and claims.

Asset based lenders historically have been the primary source of financing for distressed businesses. Lenders often make these loans at premium rates while at the same time requiring an enhanced security position. In recent years, large commercial and investment banks have formed debtor in possession lending departments to deal with the increasing number of Chapter 11 bankruptcies. Debtor in possession loans are made after a company files for bankruptcy protection. To encourage such high risk loans, bankruptcy law grants such lenders a super priority status for repayment. However, this trend is slowing as lenders move to eliminate such problem loans.

Because lenders require having a super priority status before making such loans. distressed companies sometimes file for bankruptcy just to get access to financing. Many lenders prefer the control over the borrower that bankruptcy provides. Without the court protection and supervision bankruptcy provides, lenders would likely require excessively restrictive covenants and additional fees. These restrictions and fees could hamper management from making the changes needed to speed the struggling firm's return to profitability. Therefore, a turnaround financing plan is only effective if viewed in the long term and if it ultimately helps the struggling company recover.

EQUITY INVESTORS

When unable to find a suitable lender, management of a troubled company should consider seeking investors willing to infuse equity capital into the business—known as turnaround equity investors. The advantage of equity funding is that funds are provided without interest cost and thus enhance cash flow.

As might be expected, however, raising equity funding is an expensive alternative. Equity investors typically require controlling interest in the company. Many equity investors specialize in particular industries, while others focus on companies of a certain size. All equity investors have both minimum and maximum amounts they are willing to invest. They also expect to take over a significant management role in the borrower's business.

FINANCIAL vs STRATEGIC ASSISTANCE

Since investors bring different capabilities to the table, management must determine whether financial or strategic assistance best meets the company's needs.

Financial investors often have turnaround management and bankruptcy experience and are able to assist management of a distressed firm through the complexities of reorganization. Investments are typically made at less than full value of the business's assets. Most financial investors are involved only at the board of directors level. However, some occasionally fill top management positions if necessary to protect their investment.

Some financial equity investors have funds committed and immediately available. Most, however, act as financial intermediaries who receive an equity position in the company as their compensation on completion of the investment. Such an investor acts as a liaison between the troubled company and its financing sources.

While intermediaries can access a wide variety of financing sources, management of a distressed firm should be alert to possible conflicts of interest. You should structure the engagement so that the turnaround specialist is paid only by you. This eliminates potential conflict of-interests that could arise when the specialist receives a "finder's fee" from a lender. If the intermediary stands to receive additional fees from potential lenders, management should be aware it. Such fees could prejudice the intermediary to recommend one financing source over another.

Some strategic equity investors focus on specific industries or geographic regions and generally provide specialized expertise along with their investment. These investors often acquire distressed companies to consolidate with other owned companies in the same business. Such investors also typically take over operating control of the acquired firm. For many distressed firms, whose financial condition continues to deteriorate, selling and giving up management control may be the only solution.

Whatever the source, a cash infusion from investors will give a distressed company more leverage in negotiating with creditors and lenders. Lenders look at the equity infusion as "extra protection" for their loans, thus making them more willing to modify loan agreements. Meanwhile, trade creditors may extend more favorable credit terms if they believe that an investor's cash infusion will increase their chances of eventually being paid in full.

Similarly, local governments may be more willing to provide tax concessions and financing if they believe such concessions will result in jobs saved, more taxes paid, and a business continuing to contribute to the local economy over a long run. Of equal importance, employees may more willingly consent to concessions if they believe that the company's survival is at stake, that their jobs are in jeopardy; and that they will play an integral role in the recovery.

SECURITIES AND CLAIMS TRADING

Growing numbers of investors search for opportunities to purchase securities and claims at significant discounts from financial stakeholders who prefer immediate liquidity rather than the uncertainty of recouping their investment over the long term. Such investors purchase the bankruptcy claims of the debtor's creditors. These creditors, often trade suppliers, did not enter the bankruptcy proceeding voluntarily and need the cash proceeds from their sales to the debtor. The original creditors typically are not equipped to handle the legal hardships of the bankruptcy process. In contrast, new investors believe that their investments will yield considerable returns upon the successful reorganization or liquidation of the distressed business.

Investing in bankrupt firms, also known as "trading claims," is one of the most significant bankruptcy legislative issues today. A growing number of bankruptcy judges and professionals are concerned that investors who are not creditors of a distressed company may inordinately influence bankruptcy proceedings as a result of their investment. The problem is that most such investors have never provided, and are unlikely ever to supply, goods or credit to the bankrupt company. Instead, they view bankrupt companies solely as an investment opportunity. Consequently, these creditor investors are not as concerned about successfully reorganizing a company's operations, which is the fundamental policy consideration behind Chapter 11. Instead, these investors simply want to maximize the value of their investment. Having large numbers of such investors can undermine the spirit of Chapter 11 and corporate renewal.

Purchasers of securities and claims of financially troubled companies do not infuse capital directly into the business. Instead. they take over debt owed to a creditor. Nevertheless, such investors can have a tremendous impact on a firm's turnaround effort. As debt holders. such investors have a higher priority for repayment than do equity holders if the business was to be liquidated. Also as debt holders, such investors can participate in creditor's committees of firms operating under Chapter 11 protection. Membership in such a committee enables the investor to influence the firm's reorganization efforts.

SEEKING PROFESSIONAL TURNAROUND ASSISTANCE

Perhaps the most difficult problem with financial distress is that it involves managing No processes: the business and the trouble. Managing the abnormalities of business distress is not only time consuming, but requires a special set of skills. Compounding the problem is the fact that the owner or management of the troubled business often have never faced this kind of situation before. At the same time, they are reluctant to change. This is where the turnaround specialist comes into play. Like most business consultants, the turnaround specialist offers a new set of eyes, skills, and understanding of troubled situations to independently evaluate the company's circumstances.

A fundamental question a troubled business must answer early on is what type of turnaround specialist it needs. Turnaround specialists fall into two categories: interim managers and consultants.

Interim managers replace the CEO, take the decision making reins of a troubled business, and, hopefully, guide it through its troubled waters to safety; In contrast, turnaround consultants advise existing management, sometimes working with the same management that led the company into trouble. Many times the consultant's role is to try to force managers to make decisions. Management's unwillingness to make decisions in the first place is what often leads many companies into distress.

Many troubled businesses lean toward a consultant initially because they are unwilling to turn over operations to a newcomer. Consultants advise, they don’t make decisions. However, being willing to accept an interim outside general manager may be exactly the strong medicine necessary to nurse a business back to health.

Another issue to consider is whether to hire a generalist or an expert in a particular business segment. Most managers of troubled businesses believe their problem to be unique, requiring an industry expert rather than an experienced general manager. Realistically, however, what the company needs will depend on a number of factors, including degree of financial hardship, its industry, and problems underlying the financial difficulties.

Keep in mind, however, that industry knowledge is not the same as turnaround management knowledge. Despite his initial unfamiliarity with the technical aspects of the company, a turnaround specialist often can bring a company back drawing primarily on turnaround talents.

Some turnaround specialists concentrate on varying stages of a business' decline. Some practitioners work with clients in or on the edge of bankruptcy, while others concentrate only on those who are fortunate enough to seek help early on, before the crisis is out of control

The turnaround management industry has been growing through the years partly owing to the changes in the bankruptcy laws. Pioneers executed a flurry of successful turnarounds in the late 1980s demonstrating that the profession provides a viable means of restoring troubled businesses to financial health and preserving value.

Because of the success of early turnaround consultants, the number of practitioners has increased along with the number of related support services. For example, banks now have special workout departments and some have separate operations for lending to Chapter 11 companies. Many investment firms stand prepared to purchase distressed companies. Meanwhile, consulting and accounting firms now train turnaround specialists. At the same time, law firms are changing the names of the "bankruptcy" departments to "reorganization" departments.

SELECTING A TURNAROUND SPECIALIST

Despite the pressure that management of a distressed firm faces, it needs to be careful and deliberate when selecting a turnaround specialist. Following are some suggestions to help you make the best selection:

⇒ **Be cautious and deliberate.** Retaining a turnaround specialist is like having a heart transplant, few would undergo the operation without concern. But just as a heart transplant is necessary to save the patient's life, a corporate turnaround consultant often is what is needed to keep a business alive. Like doctors, turnaround specialists use their years of experience to hone the skills that enable them to successfully restore corporations to health.

⇒ **Do your homework before interviewing a turnaround specialist.** You should obtain resumes and check references before an interview. You also should interview several candidates before deciding. Weigh what the turnaround specialist offers against what is realistically achievable. You also should contact your attorney, CPA, banker, and other financial advisors for their opinions and advice. You might also ask if the consultant has earned the certified turnaround professional designation from the Turnaround Management Association.

⇒ **When interviewing your turnaround specialist. answer his questions. Help him find the answers, and above all, listen.** Owners and management must work as partners with the turnaround specialist. You should adopt an attitude of wanting to learn all you can so chat you be ready to run the business more effectively after the turnaround specialist completes his engagement.

⇒ **Ask about the turnaround team and its work schedule.** Meet in advance with the entire team, especially those who will work on company premises. Have a clear understanding of what the turnaround specialist will handle himself and what he will delegate to others.

⇒ **Assess the chemistry among management, employees, and the turnaround team.** Maintaining a good chemistry among management, employees, and the turnaround team is critical to your company's recovery Look at character and personality of the turnaround manager, rather than his firm's reputation. A firm's reputation won't turn your company around, but a talented and charismatic turnaround manager might.

⇒ **Learn about the turnaround specialist s relationship with your lender, other potential lenders, trade creditors, and alternate suppliers.** Make sure the specialist is credible. One resource every turnaround specialist should bring to an engagement is access to credit. However, you should not expect a new lender to be more lenient. In contrast, because of the increased risk of lending to a troubled firm, a new lender likely will impose stricter covenants and additional restrictions. The lender also will charge significantly higher fees and monitor the loan much more closely. Therefore, if credibility can be re established, your "old" bank may be the company's best source of new money.

⇒ **Obtain a written proposal.** The proposal should report the turnaround specialist's initial findings, quantifiable results that you and your staff expect, and the level of company staff the support the specialist expects. The proposal also should include a timetable for completing various phases of the turnaround and who will be assigned to the engagement. It also should report how much time the turnaround specialist expects to commit to the engagement and whether the turnaround specialist will participate in implementing the plan.

In addition, the proposal should indicate the point at which the specialist will withdraw from the engagement, a complete fee structure and payment timetable, and manner in which the specialist will assist in whatever management changes are necessary. Finally, insist on a written engagement agreement before the specialist begins work.

⇒ **Ask for periodic reports from the specialist.** These reports should be concise and timely. Requiring such reports forces the turnaround specialist to organize his thoughts and review what has happened during the reporting period. Preparing such reports should not add significantly to the time required for the specialist to complete his assignment.

⇒ **Involve your staff in evaluating the turnaround specialist's performance.** Share those evaluations with the turnaround specialist.

⇒ **Demand and expect confidentiality from, and accessibility to, the turnaround specialist.** Though the turnaround specialist must be brutally honest with his client, he must also present his client in the best light possible to those outside the business. And, given precarious circumstances, the company management must have free access to the turnaround specialist.

⇒ **Do not be fooled by unemployed financing managers claiming to be turnaround specialists.** Be cautious if yours will be one of the specialist's first assignments. You may find that your specialist is merely networking to find a new job. Having a certified turnaround professional CTP designation will tell you that your specialist indeed has the skills to make a difference in your company.

HOW THE TURNAROUND SPECIALIST OPERATES

The turnaround specialist must work with management to answer questions that management has probably never asked itself, including:

- What is the purpose of this business?
- Should it be saved? If so, why? and,
- Are those reasons valid?

The turnaround specialist must gather. evaluate, and analyze information quickly so the distressed business can openly and honestly address those initial questions. That process focuses on the following issues:

- Is the business viable?
- Is there a core business that can be saved and be the source for the emerging business?
- Is there sufficient source of cash to fuel the company through recovery?
- Is current management capable of leading the company?

The turnaround specialist should discuss these questions with his client. If the answer to any of the above questions is "No," the company needs to reexamine the parameters of the engagement. Should the firm still engage a turnaround specialist? What kind of plan does the firm need to otherwise minimize losses and maximize the value of the business for the benefit of the client?

A turnaround specialist first focuses on cash flow since a cash shortage usually is what forces a troubled business to seek help. The specialist's first goal is to stabilize the cash flow. Commonly, the specialist quickly analyzes the company's sales and profit centers and its asset utilization. In many cases, these statistics indicate that the business may have "lost its focus."

To remedy the cash shortage, turnaround specialists generally analyze which assets the company can convert to generate a quick cash infusion and which operations the firm can terminate to reduce the cash outflow. These are difficult decisions since they involve downsizing the company and eliminating some jobs. At the same time, however, it preserves the good parts of the company and saves many more Jobs.

Troubled businesses often lose credibility with lenders, trade suppliers, employees, customers, shareholders, and even the local community. Retaining a turnaround specialist often is the first sign that the company is moving toward a recovery and that it is rebuilding damaged relationships. The specialist usually serves as a liaison with outside constituencies. His role is to calm troubled waters and to present bad news as a preamble to a plan for recovery.

Given management's strained credibility, the turnaround specialist helps develop a viable business plan and advocates approval and adoption by stockholders, creditors, and lenders. The specialist often must negotiate with lenders and trade suppliers in the midst of a troubled firm's financial crisis. How successful the specialist is will depend on his integrity, credibility, and track record.

The specialist often serves as the director of communication for the troubled company, dealing both with outsiders and with the employees. His job is to objectively determine what is in the best interests of the business, regardless of any other agendas that may have taken root. He must take into account the objectives of his assignment as he approaches difficult decisions.

The effective turnaround specialist also is a teacher. To be successful, he must install in the troubled company a capable management team that focuses on goals that will ensure future success. If management is "in over its head," the specialist must delicately communicate that message, identifying the appropriate role for existing managers. He also must facilitate a transition to new management whose skills better match the needs of the troubled firm.

Some turnaround specialists bring added value because they know about de nova financing sources. Other specialists have special relationships with vital industry suppliers. Thus, they can ensure a flow of essential product from suppliers that otherwise would not be available to the troubled firm.

RESISTANCE TO TURNAROUND SPECIALISTS

Given how difficult and how personal the questions are that a troubled business must face, tension often surrounds the relationships among the specialist and company owners, management, and employees. A major problem is that businesses in trouble often postpone action because the owners do not want to face the uncomfortable transition to new and more effective business practices.

Despite statistics indicating otherwise, owners and management usually believe that their business decline is unique. They attribute the problem to uncontrollable external factors and believe they can do nothing to change things.

Meanwhile, a number of misconceptions and myths make businesses leery about hiring a turnaround specialist, including the following:

⇒ ***The turnaround specialists is a heartless cut throat.*** Many believe that because of drastic cost cutting efforts, the specialist has no concern for the welfare of employees, long time suppliers, and bankers. You need to remember, however, that the job of the turnaround specialist is to make hard decisions that ownership has been unwilling to make. The specialist is obligated to tell creditors and bankers the truth—be it good or bad. He must rely on his credibility as a "straight shooter" to work with creditors and lenders to nurse the troubled firm back to health.

⇒ ***The turnaround specialist does not understand our company's culture.*** This is a legitimate observation, but it does not follow that the specialist is not capable of bringing order out of chaos and adding value to the client. One of the most appealing aspects of a specialist is that he brings a fresh set of eyes to a situation. He also comes with in depth experience and special skills needed to manage through the turnaround process.

⇒ ***The turnaround specialist does not know our business or our industry.*** The skill that the turnaround specialist brings to the table is management ability; the ability to marshal resources and maximize value from those diverse resources. If a business requires special expertise, the specialist should help finding the right expertise.

⇒ ***Employees will not cooperate with a turnaround specialist.*** Remember that management, employees, and specialist must work as a team for a turnaround to succeed. Power struggles and infighting ultimately will damage a company's chance for survival, putting all parties in jeopardy.

⇒ ***The turnaround specialist has a hidden agenda.*** Some believe a specialist wants to drive down the business' value and then purchase it at a discount. Others think he is using the company as a springboard for other opportunities and that he is not interested in the firm's long term welfare. Still others believe the specialist wants to maximize the value to ownership without regard for other company stakeholders. You should resolve all these concerns before the engagement and address each potential conflict area in the engagement agreement.

⇒ ***The turnaround specialist is not accountable for his recommendations.*** The reality, however, is that the specialist wants the best possible outcome for his client, especially since he needs to rely on referrals from current projects to acquire future business. A specialist's credibility and soundness of his recommendations are the basis on which lenders and trade suppliers will ultimately decide whether to support the turnaround effort.

⇒ ***The turnaround specialist will use his access to inside information to steal company trade secrets.*** If the company has proprietary property, it should legally protect it with trademarks or patents. In addition, an engagement agreement should describe what is considered proprietary content. The agreement should require that the specialist leave behind all sensitive materials upon completing the engagement. The agreement also should include non compete and non disclosure requirements.

CONCLUSION

Do not expect miracles overnight.

A turnaround can take years of hard work to achieve. The turnaround specialist can only be a catalyst for change. Owners and managers still must make difficult decisions to enable the turnaround process to occur.

Ultimately, a success or failure of a turnaround rests on the shoulders of a business' most valuable assets: owners, management, employees, creditors, lenders, and turnaround specialist. All must be fully dedicated to turning around the company. Outsiders will watch performance, credibility, and commitment of a company's management, employees, and turnaround specialist before giving the cooperation necessary to make the turnaround possible.

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