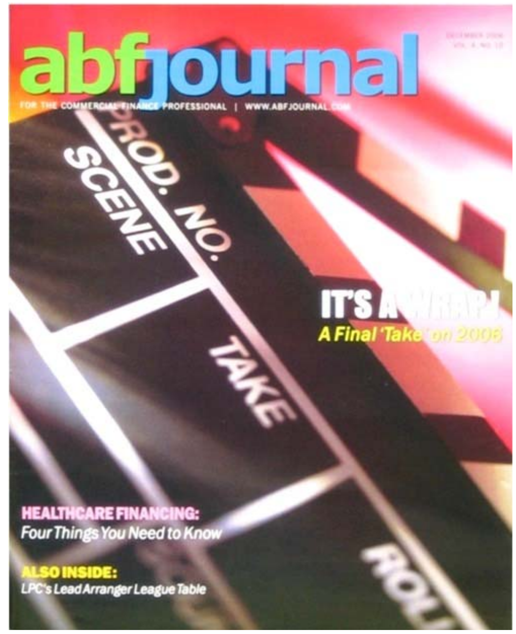
Recover & Preserve Value:

Working Successfully With Turnaround Professionals



By John M. Collard

Turnaround Corner

Part 2 of 2

How Turnaround Specialist Operates

The turnaround specialist offers a new set of eyes, skills and understanding of troubled situations to independently evaluate a company's circumstances. The turnaround specialist very quickly must face a series of questions that existing management may never have asked, such as: What is the purpose of this business? Should it be saved? If so, why? Are those reasons valid?

The turnaround specialist must gather information, evaluate it for accuracy and analyze it quickly so that those initial questions can be addressed openly and honestly. That process generally focuses upon the following issues:

- **Is the business viable?**
- **Is there a core business?**
- **Are there sufficient sources of cash to fuel a recovery?**
- **Is existing management capable of leading company?**

The specialist should discuss those questions openly with his client, and if it is determined the answer to any of the above questions is "No," the parameters of the engagement should be reexamined. Should a specialist still be engaged? What kind of plan is needed to otherwise minimize the losses and to maximize the value of the business for the benefit of his client.

The process of recovery undertaken by the turnaround specialist involves several stages.

Fact-finding. The turnaround specialist must learn as much as possible as quickly as possible so that he can assess 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 possible courses of action. Depending upon the engagement and who his client is, the specialist will seek client input to determine which of alternative courses of action should be undertaken.

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

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

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

Turnaround specialists immediately focus on cash flow since it is often a cash shortage that causes troubled businesses to seek help. The specialist's first goal is to stabilize cash flow and stop the hemorrhage. The specialist performs a quick analysis of the company's sales and profit centers and of its asset utilization.

In many cases, these factors indicate that the business may have lost focus of its core. To remedy cash shortage, turnaround specialists generally analyze which assets are available to generate a quick infusion of cash and which operations could be terminated thereby stopping the cash outflow. These are difficult decisions since they intrinsically involve down-sizing the company and eliminating some jobs. On the other hand, it has the effect of saving the good parts of the company - and many jobs.

After the specialist has been engaged and a business plan designed, the specialist plays many roles. Since many troubled businesses often lose much of their credibility with lenders, trade suppliers, employees, customers, shareholders, and the local community at large, retaining a turnaround specialist is often the first sign to outsiders that the company is taking positive steps toward both recovery and rebuilding damaged relationships. The turnaround specialist usually serves as a liaison or intermediary with these outside constituencies to calm troubled waters and to present bad news as a preamble to a plan for recovery.

Because management's credibility is often strained, the specialist actively assists in the preparation of a viable business plan and advocates its approval and adoption by the various constituency groups whose cooperation is necessary for implementation. The turnaround specialist is experienced in negotiating both with lenders and with trade suppliers in the midst of a crisis. The turnaround manager brings their personal integrity, their own credibility, and their track record to the table in contrast to that offered by existing management, which finds itself in a downturn.

The turnaround specialist often directs communication for the troubled company with outsiders and company employees. The job of the turnaround specialist is to determine what is in the best interests of the business objectively, regardless of any other agendas. The turnaround specialist must take into account the objectives of the assignment and approach difficult decisions without the weight of historical expectations on his back.

The effective turnaround specialist is a teacher and knows that it is critical to success that a capable management team with acute awareness of its goals must be left behind. If management is deficient, the turnaround specialist has the very delicate task of communicating that message, identifying appropriate roles for existing managers and facilitating a transition.

Special skills the turnaround specialist may also bring to the engagement include knowledge of sources of *de nova* financing and familiarity of trade relationships necessary to assure the flow of product the company needs to fuel its recovery.

Business Ownership's Resistance to Turnaround Specialists

Given difficult questions that a troubled business must face, there is often tension between owners, management, employees of the company and the turnaround specialist. One main problem is that businesses in trouble will often postpone action because their own owners no longer can tolerate jarring change and an uncomfortable transition to something new. Despite statistics indicating otherwise, owners and management may generally believe that its particular situation fits within those minority cases in which decline is attributable to uncontrollable external factors.

A variety of misconceptions and myths abound, which make businesses leery about hiring a turnaround specialist.

The turnaround specialist has "no heart". He does not care about employees, long-time suppliers or bank with whom the company has been doing business for many years. He is cutting employees and telling creditors that they are not going to be paid. Do not forget that the specialist is goal oriented and recognizes that his job is to make hard decisions. The turnaround specialist is an experienced negotiator with creditors to whom he tells the truth, be it good or bad and relies upon his credibility to build the consensus necessary to build for the future.

The turnaround specialist does not understand the company's corporate culture. This is a legitimate observation, but it does not follow that without history on his side, the turnaround specialist is not capable of bringing order out of chaos and adding value to the client. One of the most appealing aspects of a turnaround specialist is that he brings a new set of eyes to a situation as well as an experienced and knowledge base of managing businesses through the turnaround process.

The company's employees have no loyalty to the turnaround specialist. Just remember that management, labor and the turnaround specialist have a responsibility to the organization to work together for the common good, and any power struggles will ultimately hurt the company and the turnaround effort.

The turnaround specialist does not know the client's particular business or industry. The skill the specialist brings to the table is his management ability, his ability to marshal resources and maximize the value from those diverse resources. If the business requires special expertise, the turnaround specialist should assist in attracting that expertise. Most importantly, these issues should be discussed prior to the engagement.

The turnaround specialist has a private agenda. The specialist is ultimately interested in purchasing the business, is using the business as a springboard into other ventures, or is there to maximize value to his referral source without regard to the other stakeholders. These issues with particular emphasis on independence should be addressed pre-engagement and potential conflicts should be addressed in an engagement agreement.

The turnaround specialist will not have to live with his recommendations for change and probably will not even live in the community beyond the period of the engagement. As a result, the turnaround specialist is not accountable to anyone. In reality, however, the turnaround specialist is motivated to perform the best if the troubled company is used for purposes of future references or if the company reports the results of the engagement to the referral source. The turnaround specialist's credibility and recommendations are the basis upon which lenders and trade suppliers will ultimately rely in deciding whether to offer support – and throw future business his way.

The turnaround specialist will steal ideas, techniques. If the company has proprietary property, it should legally protect itself. Otherwise, engagement agreement should cover points of privacy or proprietary content which the turnaround specialist must leave behind or be restricted through contract provisions similar to non-disclosure and non-compete agreements.

Remember to Be Cautious

Because the number of successful corporate turnarounds has been steadily increasing during the past few years, the increased visibility of the industry has attracted operators masquerading as qualified turnaround specialists. The expression "Ready, Shoot, Aim," rings all too familiar. Businesses seeking management assistance should be cautious to carefully consider each turnaround candidate.

Beware of the turnaround specialist who refuses to supply references. Since the profession is relatively young, there is limited general knowledge in the marketplace regarding the capabilities and backgrounds of turnaround specialists. Particularly, check with attorneys and CPAs with whom the turnaround specialist has worked and obtain as much specific information regarding the turnaround specialist's actual experience as possible. The TMA has implemented a Certified Turnaround Professional (CTP) designation, which checks professional and client references, and requires CTP to pass a three-part rigorous examination before qualification.

Like any professional, the competent turnaround specialist will not guarantee results whether it be a recovery, new funds, a renegotiated loan, an equity investor or buyer, or any other guaranteed result. A guarantee of any result, other than a best effort, is a signal to keep interviewing.

If the turnaround specialist makes an effort to impress the company with his particularly close relationship with banks, trade suppliers, investor, or any particular resource the business may need, investigate that particular relationship further. Make sure that the turnaround specialist has adequate independence from other sources so that he can provide the company not only with his undivided attention, but also so that the company can be comfortable that his advice and leadership will be void of any possible conflicts of interest.

A turnaround specialist who tries to impress the company with a "look how much our firm has grown" sales approach is equating quantity with quality. The implication is that the firm has grown because the marketplace recognizes the quality of the work performed.

The issue of the turnaround specialist taking equity is a double-edged sword. Some turnaround specialists believe that taking equity or having an opportunity to receive an equity position with a client is a conflict of interest, which could impair their management judgment. Others believe that, as an equity holder, the turnaround specialist not only shares the risk but also must maximize shareholder value, and therefore, benefit all constituents, to receive the full compensation. This is effectively the same theory underlying stock option plans for management in many companies. Regardless of whether equity participation is good or bad, the company and the turnaround specialist should fully discuss equity participation prior to the engagement and define the potential role of equity, if any, in the engagement agreement prior to employment.

Investigate the turnaround specialist's actual experience. Ask what portion of this business has actually been in turnaround situations rather than in other executive or consulting capacities. Although the number of turnaround specialists is rather small at this time, try to avoid providing a job in transition for an executive or a training ground for a consultant.

When discussing fees, provide specifically for what expenses are to be reimbursed and the level of reimbursement generally expected. Most importantly, do not let it become either a surprise or a source of disagreement. Again, cover as much as possible prior to the engagement in a written engagement contract.

Engagement Agreements

Always insist upon a written engagement agreement to outline the terms of the engagement. Provisions that should at least be considered include:

- **The purpose of the engagement.**
- **General responsibilities of the turnaround team, the company's management and staff.**
- **Time the specialist will devote to company. (What other commitments must specialist deal with simultanously?)**
- **Specialist's staff.**
- **Company staff.**
- **Specialist's core of professional support for the business (attorneys, accounting firms, etc.).**
- **Terms of any equity opportunities for the specialist (The entire question of the turnaround specialist and equity is one of the more troublesome in this growing profession. It is critical that all parties understand the rules up front. For example: discuss equity kickers, the specialist as an equity participant, finder's fees, etc.).**
- **Term of the engagement (Define the time period of the engagement).**
- **Fee arrangement, terms of performance bonuses, payment schedule.**
- **Project "deliverables" (What the specialist is expected to deliver, even if it is only a best effort. A schedule of anticipated benchmarks where both parties may measure progress and satisfaction with the other.)**
- **Fee for acting as a broker in selling the business.**
- **Regular reporting mechanism (to assure communication between the parties.)**
- **Specialist's follow-up responsibilities after the engagement is concluded.**
- **Termination provisions (includes notification periods, for both parties.)**

Turnaround Financing For Financially Distressed Companies

While most owners of distressed businesses believe that access to more money would solve their company's financial problems, turnaround specialists recognize that the shortage of capital is often only a symptom, rather than the primary problem facing a distressed company. Although sufficient and available financial resources are necessary to implement turnaround plans, a successful turnaround must first attack and solve the business problems which produce the cash crisis.

Financing is an integral part of a troubled company's plan of reorganization. An effective financing plan will stabilize the cash position during crisis, provide necessary capital base to allow the company to return to profitability, and restructure the balance sheet so it can support the company into the future.

Financing strategies differ from situation to situation according to the liquidity and viability of the distressed business. Initially, turnaround specialists attempt to maximize the liquidity to provide sufficient time to evaluate the viability of the business. In addition, the turnaround specialist is likely to implement cost reduction plans and attempt to renegotiate the terms and covenants of existing financing arrangements to a level the company can live with during the recovery period.

When necessary, the turnaround-financing plan can involve a recapitalization, or a restructuring of the right side of the balance sheet. This involves changing the relationship between existing financial stakeholders through a combination of debt and equity conversions, exchange offers, stock rights offerings, and the addition of new financial stakeholders. Obviously, the more sever a company's situation is, the more difficult it is to work out an arrangement with existing trade creditors, lenders, equity holders, and the harder it is to attract new stakeholders.

Turnaround financing specialists provide financially distressed companies a number of financial resources and expertise to draw upon. Capital resources and the range of services differ widely among lenders, equity investors, and purchasers of securities and claims of distressed companies.

Historically, asset based lenders have been a primary source of loans to distressed businesses. These loans are often made at premium rates while the lender requires an enhanced security position. With the increasing number of Chapter 11 bankruptcies, debtor-in-possession lending departments emerged in many large commercial banks and investment banks. Debtor-in-possession loans are made to a company after it files for bankruptcy protection. To encourage these lenders to undertake the risks, the law provides a super priority status for repayment of their loans.

Actually, because of this super priority status, some companies must file a bankruptcy case to provide the lender with the level of security it seeks. Ironically, many lenders prefer the control aspect of the bankruptcy process. Without court's protection and supervision, in a non-bankruptcy environment, these same lenders may well lend to a distressed company but with restrictive covenants and fees that may seem burdensome. In addition, taking into account the higher fees and rates - coupled with other restrictions to be anticipated in a distressed situation - management flexibility is limited and higher interest rates often slow the recovery. Therefore, the turnaround-financing plan is only effective if viewed on a long-term basis, and if it ultimately helps the company achieve recovery.

When a distressed company is unable to find a suitable lender, management should consider ***turnaround equity investors*** who will infuse equity capital into the business. As one would anticipate, equity funds are also an expensive alternative. Equity investors typically require a controlling interest in the company in exchange for their capital and in consideration of the abnormal risk. Equity investors often specialize in particular industries, company sizes, investment minimums and maximums, and anticipate varying management roles. Since investors bring different capabilities to the table, management should determine whether the company would best be served by financial or strategic assistance.

Financial investors sometimes have turnaround management and bankruptcy experience and are able to assist management through the complexities of the reorganization process. Investments are often made at a significant discount compared to the business's underlying asset value. While most financial investors remain involved only at the board of director level, they occasionally fill top management positions if necessary to protect their investment.

While some financial equity investors have funds committed and immediately available, others act as financial intermediaries receiving an equity position in the company as their compensation upon completion of the investment. These investors act as a "gate keeper" between the financially distressed company and the alternative ***sources*** of financing. While many financial intermediaries are skilled financial advisors and have a wide network, management should be aware of possible conflicts of interest between the advice they receive from the financial intermediary and his compensation arrangement. Full disclosure should be sought to assure that the primary motivation for putting the deal together is not the fee involved.

Alternatively, ***strategic equity investors*** are identified by their specific industry or geographic requirements and generally provide specialized experience and knowledge with their investment. These investors often acquire financially distressed companies to consolidate with their existing companies and typically become involved in the management of the acquired business at a senior operating level. Since the passage of time usually works against a financially distressed company, the strategic investor may provide the company with a more timely, or occasionally, the only solution.

Regardless of the type of equity investor, the financially distressed company will often benefit from the increased negotiating leverage with its constituencies that a credible new investor brings to the turnaround. Once new equity funds are infused into the business, the company's existing lender may be more willing to modify the loan agreement if they feel that their loan is protected from further impairment. Trade creditors may agree to credit terms more favorable to the troubled business if they believe that future payments have become more certain and if no trade creditors are being preferred over others. A local government may be more willing to provide tax concessions and financing if it believes jobs will be saved so that the business can continue to contribute positively to the local economy. Of equal importance, employees may be more willing to consent to concessions if they believe that the company's survival is at stake, that their jobs are in jeopardy, and that they are an integral part of the recovery process.

Purchasers of securities and claims of financially distressed companies do not infuse capital directly into the business. However, management should be aware that these investors can have a tremendous impact on the company's turnaround efforts through their purchase of securities and claims from the existing financial stakeholders. Investments are typically made in company's debt, since in a bankruptcy, debtholders have a higher priority status than equity holders and are able to influence management's reorganization efforts through participation on the creditors' committee. In some cases, these investors will infuse equity capital into the business as part of the plan of reorganization to increase the returns on their investments.

This growing number of investors look 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. They believe that their investments will yield considerable returns upon the successful reorganization of the financially distressed business.

Experienced turnaround specialists have networks to assist their clients to find the funds necessary to fuel the recovery.

A Final Word of Advice...

Do Not Expect Miracles Overnight.

The turnaround can take years of hard work to achieve, the turnaround specialist can only be a catalyst to change. Owners must make hard decisions enabling the process to take place.

Ultimately, success of a turnaround rests upon the shoulders of a business' most valuable assets, albeit not shown on any balance sheet: its turnaround leadership, its owners and lenders, its management and its employees all dedicated to turning around the company. It is upon their effort, performance, credibility, and commitment that the turnaround specialists, lenders and creditors, and the marketplace, ultimately rely. **abfj**

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