Recover & Preserve Value:
Working Successfully With Turnaround Professionals

SMP Library
Articles of Interest

Strategic Management Partners

A nationally recognized turnaround management firm specializing in interim executive leadership, asset recovery, investing in underperforming distressed troubled companies.

Article *SMP Home Page* *Contact SMP*
SMP Library - Articles of Interest

Nov 2006

Dec 2006

Turnaround Corner

Recover & Preserve Value: Working Successfully With Turnaround Professionals *Text*

By John M. Collard

ABF Journal
For The Commercial Finance Professional

SECTIONS:

Article Text
About the Author
About the Firm
PDF Version - Part 1 of 2
PDF Version - Part 2 of 2
ABF Journal, Recover & Preserve Value, Part 1 of 2
ABF Journal, Recover & Preserve Value, Part 2 of 2

Sections Index

Turnaround Corner

Recover & Preserve Value:
Working Successfully With Turnaround Professionals

By John M. Collard

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 the turnaround specialist brings his/her art to the process.

The identity of the client must be clear. The client's identify 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 a company's operational performance include:

- **Decrease in profit**
- **Lack of both short- and long-term planning and forecasting**
- **Quality control problems - 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 returning telephone calls**
- **Delay in submitting financial statements to banks, lenders, and suppliers**
- **Board of Directors resignations**
- **Auditor resignations or turnover**
- **Failure of board of directors to diligently exercise its oversight function**
- **Return of the "retired" founder to a 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 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**
- **Acquisitions of or expansion into non-core related businesses or into businesses 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: $Z = 1.2A + 1.4B + 3.3C + 0.6D + 1.0E$

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 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 both 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 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 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 turnaround 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.

How Turnaround Specialist Operates

The turnaround specialist offers a new set of eyes, skills and understanding of troubled situations to independently evaluate the 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 the company through its recovery?**
- **Is existing management capable of leading company?**

The turnaround specialist should discuss those questions openly with his client, and if it is determined that 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 and suggesting possible courses of action. Depending upon the engagement and who his client is, the turnaround specialist will seek the input of his client 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 turnaround specialist should be involved in putting the plan into place whether 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.

Turnaround specialists immediately focus on cash flow since it is often a cash shortage that causes troubled businesses to seek help. The turnaround specialist's first goal is to stabilize the cash flow and to stop the hemorrhage. The turnaround specialist usually 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 the 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 turnaround specialist has been engaged and a business plan has been designed, the turnaround specialist plays many roles. Since many troubled businesses often lose much of their credibility with lenders, trade suppliers, employees, customers, shareholders, and even 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 turnaround 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 some 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 the employees, the long-time suppliers or the 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 turnaround 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 turnaround specialist does not know the client's particular business or industry. The skill the turnaround 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 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 has a private agenda. For example, the specialist is ultimately interested in purchasing the business, is using the business as a springboard into other ventures, or is there to maximize the 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 or techniques. If the company has proprietary property, it should legally protect itself. Otherwise, the 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 the specialist deal with simultaneously?)**
- **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.**
- **Fee for acting as a broker in selling the business.**
- **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.)

- **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 company's cash position during the crisis, provide the necessary capital base to allow the company to return to profitability, and restructure the balance sheet so that 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 company's 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 company's 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 also 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 itself can take years of hard work to achieve, and the turnaround specialist can only be a catalyst to the change. Difficult decisions must be made by owners to enable this process to take place.

Ultimately, the success or failure 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.

ABF Journal, Recover & Preserve Value, Part 1 of 2

ABF Journal, Recover & Preserve Value, Part 2 of 2

About the Author

John M. Collard is chairman of Strategic Management Partners, Inc., a turnaround management firm based in Annapolis, maryland, and specializing in interim executive leadership and investing private equity in underperforming companies. He is past chairman of the Turnaround Management Association and brings 35 years senior operating leadership, $85M asset recovery, 40+ transactions worth $780M, and $80M fund management expertise to advise company boards, institutional and private equity investors, and governments. For more information about Strategic Management Partners, call (410) 263-9100 or visit www.StrategicMgtPartners.com

Sections Index Contact

About the Firm

Strategic Management Partners has substantial experience advising corporations and individuals on the strategic and mechanical issues of corporate development and governance, operating management and turnarounds for asset recovery. Our principal has over 30 years experience in P/L Management, Strategic Planning and Repositioning, M&A for Strategic Advantage, Finance, Investing, Raising Funds, Sales/Business Development, Building Selling and Marketing Teams, and Operational Auditing = In Public & Private companies = In healthy and crisis situations.

We work with and support the equity capital community to provide assessment studies to determine the situation, planning and strategy development to direct the company, crisis management to oversee that assets are not squandered away, workout teams that recover assets, and board level oversight to keep the client headed in the right direction.

We seek strategic alliances with private equity and recovery funds.

Sections Index

We welcome constructive inquires. More information is available if required.

There is more to Strategic Management Partner's ***Return to Home Page***

Contact Information

Index

John M. Collard, Chairman
Strategic Management Partners, Inc.
522 Horn Point Drive
Annapolis, Maryland [MD] 21403
Voice 410-263-9100 Facsimile 410-263-6094 E-Mail Strategist@aol.com.

We serve as experts for comment or quote, please contact us at **410-263-9100**

We welcome constructive inquires, please send via E-Mail to: Strategist.

Top ***Index*** ***Sections*** ***Contact*** ***PDF Part 1 of 2*** ***PDF Part 2 of 2***
SMP Library
www.StrategicMgtPartners.com
www.StrategistLibrary.com
www.StrategistArticle.com
www.StrategistFeature.com