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Keys to operational and financial restructuring of smaller companies

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The Situation

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Paths of a Turnaround or Restructuring

The transition to a Crisis can take weeks, months or years depending on many factors, such as:

- the industry
- the degree of indebtedness
- the availability of capital
- the nature of the causes of poor performance

Non-Crisis

Crisis

Financial Position

Time

Turnaround strategies adopted

Insolvency

Sustainable Recovery

Mere Survival

Short-Term Survival

Failed Turnaround

Source: Corporate Recovery: Managing Companies in Distress, by Stuart Slatter & David Lovett

Causes of Distress

External

Changes in Market Demand

- Housing market
- *Coal industry*

Competition

- New competition
- Change in relative competitive position
- *Brick and mortar retail vs.* online

Change in Costs

- Adverse change in commodity prices
- *Disconnect with customer contracts*

Internal

Poor Management

- Not necessarily incompetence but poor team dynamic

Inadequate Financial Control

- Failure to identify declining performance and take action

High Cost Structure

- Fixed costs may have increased as a result of an attempted growth push

Loss of Talent

- Or mis-alignment of resources due to management changes

Poor Marketing

- Lack of focus on selling and marketing efforts

Big Projects / Acquisitions

- Poor integration
- Distraction from core competencies
- Drain on financial resources

Capital Structure / Leverage

Crisis Indicators

The #1 indicator of a crisis or that a crisis may occur is the inability of management to fully acknowledge its problems and to articulate a clear path to resolution.

- Turnover in key positions
- Loss of credibility with stakeholders
- Lender tightening borrowing lines
- Vendors requiring COD/CIA
- A/P increasing
- A/R aging
- Ineffective forecasting
- Lack of coordination between sales and operating departments
- Production problems
- Deferment of major repairs
- Forecasts which depend on unrealistic home runs

Impact of a Crisis on the Organization

A company's culture can decline dramatically during a crisis if not managed with sufficient, effective communications.

1. Hidden Crisis

Complacency: Signals completely overlooked

2. Crisis Denial

Crisis explained away: Belief that it will disappear; no need for action

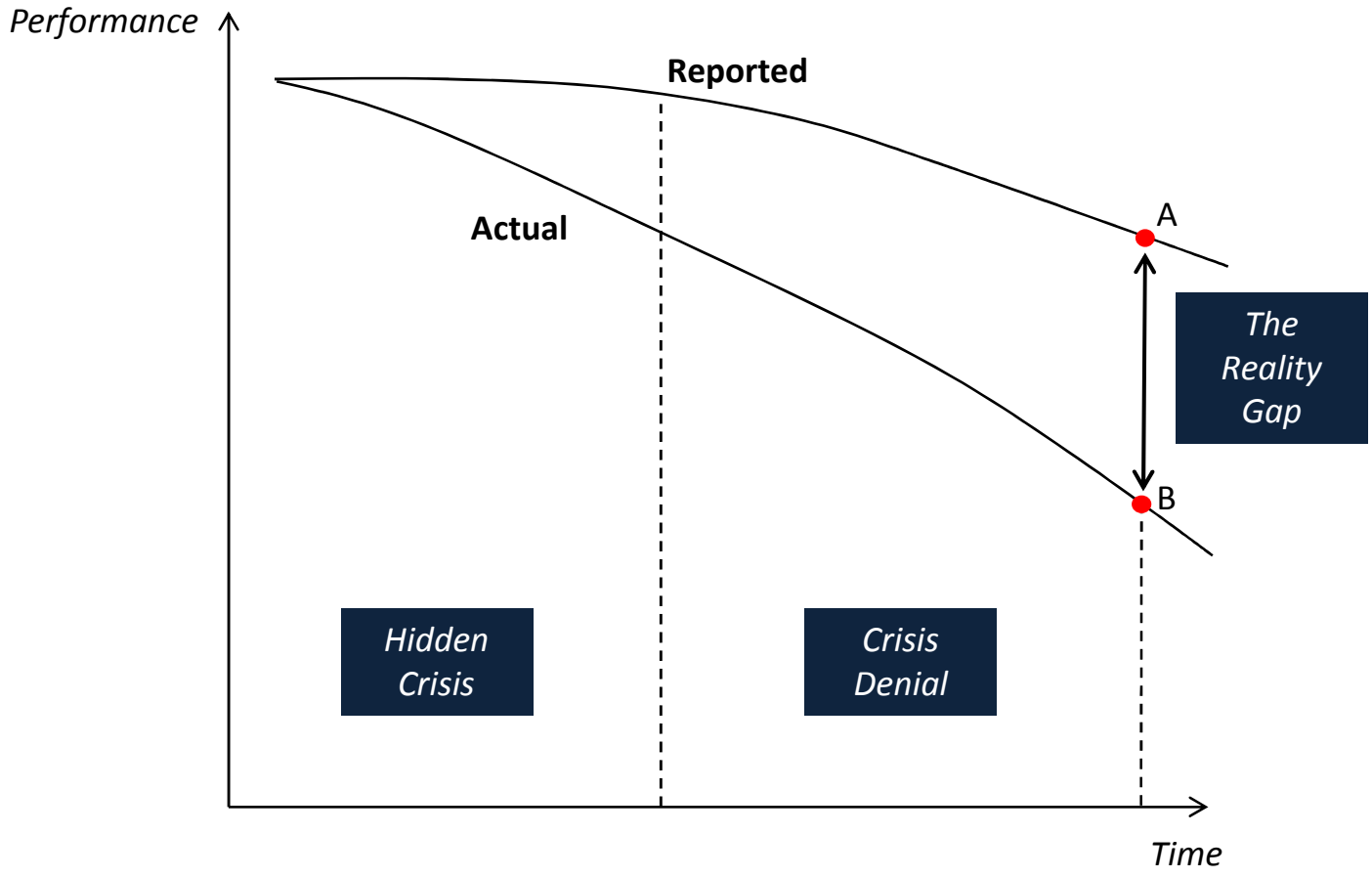
3. Disintegration of Organization Begins

Some action taken but need for action under estimated – Optimism "We are Ok" self preservation and beginning of creative accounting.

4. Organizational Collapse

Inability to take action

Creative Accounting – How did company get so bad so fast?



Source: Corporate Recovery: Managing Companies in Distress, by Stuart Slatter & David Lovett

Basic Requirements for Turnarounds

A crisis is frequently necessary before change can be achieved, since it is only then that the necessary organizational "re-learning" can take place.

- Sometimes the dysfunction that precedes the start of a turnaround can actually facilitate a turnaround. This comes about because organizations have to "re-learn" what they know before they can start to be "re-programmed". For example, they have to:
  - Lose confidence in their old leaders before they will listen to new leaders
  - Abandon their old objectives before they will adopt new ones
  - Reject their perceptual filters before they will notice events they had previously overlooked
  - See that their old methods do not work before they will invest in and adopt new methods

The One-Two Combo Punch

- Grind out the facts
  - Debunk company and industry folklore with facts
- Acknowledge problems and develop new thinking to address change

GETTING STARTED:

- Prepare to meet management
- Obtain, review and summarize financial information
- Obtain, review management organization chart and business organization charts
- Conduct initial meeting with CEO/CFO
- Develop an understanding of the business
- Review financial issues – Do they understand the gravity of the situation?
- Conduct meetings with other team members – middle management
- Organize a tour of the facility
- Record observations and form an initial hypothesis
- Record initial views of management

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Developing Turnaround Strategies

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Turnaround Process - Four Key Objectives

Successful turnarounds are based on addressing both strategic and operational issues and by doing so, creating a new EBITDA engine. Only then can a new financial structure be put in place to match the new EBITDA engine.

Four Key Objectives

1. Take Control of the Situation

- *Crisis stabilization*
- *Leadership*

2. Rebuild Stakeholder Support

- *Stakeholder management*

3. Fix the Business

- *Strategic focus*
- *Organizational change*
- *Critical process improvements*

4. Resolve Future Funding

- *Financial restructuring*

Phases of the Turnaround Process

Survival Phase → **Stability Phase** → **Growth Phase**

The Seven Essential Ingredients

To achieve the key objectives, there are seven essential ingredients.

Seven Key Ingredients	Generic Turnaround Strategies
Crisis Stabilization	• Take Control • Cash Management • Working Capital Reduction • Asset Reduction • Short-term Financing • First-step cost reduction
Leadership	• "Critical Mass" of New Thinking • Potential Change of Senior Management
Stakeholder Support	• Communications
Strategic Focus	• Redefine Core Businesses • Divestment and Asset Reduction • Product-Market Refocusing • Downsizing • Outsourcing • Investment
Organizational Change	• Structural Changes • Key People Changes • Improved Communications • Building Commitment and Capabilities • New Terms and Conditions of Employment
Critical Process Improvements	• Improved Information and Control Systems ("Management Accounting") • Improved Sales and Marketing • Cost Reduction • Quality Improvements • Improved Responsiveness
Financial Restructuring	• Refinancing • Asset Reduction

1) Crisis Stabilization

Take Control of Check Book

- Review EVERY disbursement for necessity

Develop a 13-Week Cash Flow Projection

- Why? →
- The forecast allows you and management to understand:
  - Major Cash Sources & Uses
  - Operational Structure
  - Primary Assets
  - Variable and fixed expenses
  - Core vs. Non-Core divisions
- The forecast and analysis is crucial to help understand the following:
  - Is there an immediate cash crisis?
  - Does the Company need to find alternative financing?
  - Does the Company need to file for bankruptcy?
  - What areas of the business use the most capital?
  - Does the Company have working capital problems. If so, where?
- Once the forecast is finalized, it will be presented to management, lenders, and other stakeholders as required and used to Run the Business.

1) The process of developing a 13-week cash projection is the best way to quickly understand critical business issues and the essence of a business.
2) To use as a "reality tool" to help management break out of denial.
3) To understand cash flow of the business and plan appropriately.
4) To quantify how much time to develop/effect the turnaround (the "liquidity runway").

1) Crisis Stabilization – Mechanics of a 13-Week Cash Flow Projection

- Granular detail, “Direct” cash flow
- Not GAAP cash flow statement (Indirect)
- Not an “Excel model” but a comprehensive “process” that must be used over an extended period of time
  - Must develop primary drivers of business and how to include in model
  - Find historical data in accounting systems
  - Why . . . Why . . . Why . . .
  - Must be able to cost effectively pull actual results on a timely basis from books for use in weekly variance analysis
  - Talk to management and staff not just at the top, but also middle levels and “DOERS”

1) Crisis Stabilization – Building the Forecast

- **Talk with key management and staff – Get out in the Company**
  - Treasurer
  - Controller
  - CFO
  - Accounts Receivable manager
  - Head of Sales
  - Head of Purchasing
  - Ask general questions and let them talk about their business
  - Connect with management and staff
  - Explain the goal of generating a bottoms up forecast in a relatively short time frame
- **Historical Financials**
  - Historical financial information will be the anchor and ultimate "vet" of your forecast
  - Try to obtain access to the following electronic files for at least six months and up to two years if possible:
    - Monthly financial statements (income statement, balance sheet and cash flow)
    - Sales by division / segment / operation
    - Accounts payable check runs
    - Payroll and other human resources payments
    - Key vendor payments
    - Capital expenditures
  - Analyze the financials to understand where and when the cash was disbursed

1) Crisis Stabilization – Building the Forecast (cont.)

- **Company Cash Flow Forecast**
  - Find out if the Company has a treasury forecast or any other tools they use to manage cash flow
  - Obtain old forecasts and compare these to actual results
  - Identify their view of major sources and uses
- **Other Treasury Tools (if the Company doesn't have a cash flow forecast)**
  - Historical bank balances by division or segment
  - Cash/bank reconciliations
  - Monthly reporting packages that illustrate cash sources and uses
- **Seasonality and Working Capital Requirements\One Time Cash Needs**
  - If seasonality of the cash flow is not properly forecast, timing issues may occur and the Company may be negatively impacted by working capital requirements on a weekly and monthly basis
  - Seasonality effects both receipts and disbursements of the Company, including:
    - Paying vendors, Purchasing raw materials, Collecting receivables
    - Vendor terms may change over the course of a year (depending on the industry)
    - Certain companies may require an "inventory build" heading into their busier seasons
- **Use historical financials, seasonality, working capital requirements and one time cash needs to ensure that the 13-week cash flow forecast correctly captures cash sources and uses both short and long-term**
- **DETAIL . . . DETAIL . . . DETAIL**

1) Crisis Stabilization – Example 13-Week Forecast

Company A
13-Week Cash Flow Forecast
($ in thousands)

		1 WE 8-3	2 WE 8-10	3 WE 8-17	4 WE 8-24	5 WE 8-31	6 WE 9-7	7 WE 9-14	8 WE 9-21	9 WE 9-28	10 WE 10-5	11 WE 10-12	12 WE 10-19	13 WE 10-26	13 week Total
Cash Receipts															
Operational Cash Receipts	A	2,595	2,639	2,677	2,712	2,743	2,770	2,795	2,817	2,836	2,854	2,842	2,832	2,823	35,936
Other	B	-	-	-	-	250	-	-	-	500	-	-	-	-	750
Total Cash Receipts		2,595	2,639	2,677	2,712	2,993	2,770	2,795	2,817	3,336	2,854	2,842	2,832	2,823	36,686
Operating Cash Disbursements															
Supplier Payments	C	(2,190)	(2,128)	(2,075)	(2,029)	(1,989)	(1,954)	(1,952)	(1,950)	(1,948)	(1,947)	(1,884)	(1,831)	(1,787)	(25,664)
Human Resources Payments	D	(625)	(65)	(625)	(65)	(625)	(65)	(65)	(675)	(65)	(565)	(65)	(565)	(65)	(4,135)
Rent	E	(400)	-	-	-	-	(400)	-	-	-	(400)	-	-	-	(1,200)
Utilities	F	(250)	-	-	-	(250)	-	-	-	-	(250)	-	-	-	(750)
Taxes	G	-	-	-	-	-	-	-	-	-	(250)	-	-	-	(250)
Insurance	H	-	-	-	-	-	-	-	-	-	(300)	-	-	-	(300)
Capital Expenditures	I	-	-	(250)	(50)	-	-	-	-	(75)	-	-	-	-	(375)
Professional Fees	J	(100)	-	-	-	(1,000)	-	-	-	-	(1,275)	-	-	-	(2,375)
Total Operating Cash Disbursements		(3,565)	(2,193)	(2,950)	(2,144)	(3,864)	(2,419)	(2,017)	(2,625)	(2,088)	(4,987)	(1,949)	(2,396)	(1,852)	(35,049)
Debt Service															
Interest	K	-	-	-	-	(642)	-	-	-	(516)	-	-	-	(510)	(1,667)
Amortization	K	-	-	-	-	-	-	-	-	(5,000)	-	-	-	-	(5,000)
Total Debt Service Disbursements		-	-	-	-	(642)	-	-	-	(5,516)	-	-	-	(510)	(6,667)
Total Disbursements		**($3,565)**	**($2,193)**	**($2,950)**	**($2,144)**	**($4,506)**	**($2,419)**	**($2,017)**	**($2,625)**	**($7,604)**	**($4,987)**	**($1,949)**	**($2,396)**	**($2,361)**	**($41,717)**
Net Cash Flow		**($970)**	**$445**	**($272)**	**$568**	**($1,513)**	**$351**	**$778**	**$192**	**($4,268)**	**($2,134)**	**$893**	**$436**	**$462**	**($5,031)**
Cash & Liquidity															
Beginning Cash		$5,000	$5,000	$5,445	$5,173	$5,741	$5,000	$5,351	$6,129	$6,321	$5,000	$5,000	$5,893	$6,329	$5,000
Change in Cash		(970)	445	(272)	568	(1,513)	351	778	192	(4,268)	(2,134)	893	436	462	(5,031)
Revolver Draw		970	-	-	-	772	-	-	-	2,947	2,134	-	-	-	6,822
Ending Cash		$5,000	$5,445	$5,173	$5,741	$5,000	$5,351	$6,129	$6,321	$5,000	$5,000	$5,893	$6,329	$6,791	$6,791
Revolver Availability	L	2,175	2,175	2,175	2,175	1,403	1,869	1,869	1,869	(1,079)	(3,422)	(3,422)	(3,422)	(3,422)	(3,422)
Total Liquidity		**$7,175**	**$7,620**	**$7,348**	**$7,916**	**$6,403**	**$7,220**	**$7,998**	**$8,190**	**$3,921**	**$1,578**	**$2,471**	**$2,907**	**$3,370**	**$3,370**
Credit Facility Rollforward															
Beginning Revolver		$25,000	$25,970	$25,970	$25,970	$25,970	$26,742	$26,742	$26,742	$26,742	$29,689	$31,822	$31,822	$31,822	$25,000
Revolver Draw / (Paydown)		970	-	-	-	772	-	-	-	2,947	2,134	-	-	-	6,822
Ending Revolver		$25,970	$25,970	$25,970	$25,970	$26,742	$26,742	$26,742	$26,742	$29,689	$31,822	$31,822	$31,822	$31,822	$31,822
;Term Loan Rollforward															
Beginning Term Loan		$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$45,000	$45,000	$45,000	$45,000	$50,000
Draw / (Paydown)	K	-	-	-	-	-	-	-	-	(5,000)	-	-	-	-	(5,000)
Ending Term Loan		$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$45,000	$45,000	$45,000	$45,000	$45,000	$45,000
Total Financing		**$75,970**	**$75,970**	**$75,970**	**$75,970**	**$76,742**	**$76,742**	**$76,742**	**$76,742**	**$74,689**	**$76,822**	**$76,822**	**$76,822**	**$76,822**	**$76,822**

1) Crisis Stabilization – Example 13-Week Forecast

Company A
13-Week Cash Flow Forecast

Line Item	Description
Operational Cash Receipts	Forecasted cash receipts for normal course of business. Forecast developed utilizing Sales & COGS forecast for three months ending October 2013. DSO's for both US and Foreign Operations based upon historical information and current run-rate.
Other Cash Receipts	Forecast reflects a tax refund check to be received by the US Operations at the end of September 2013 and the sale of a Foreign vacant facility at the end of August 2013
Production / Supplier Payments	Forecasted Production / Supplier payments based upon historical percentage of payments compared to total disbursements made out of accounts payable. Utilized percentage to estimate prior period accounts payable roll forward for Production / Supplier payments to calculate estimated historic DPO's for both US and Foreign operations. For forecast utilized COGS from Sales & COGS forecast for three months ending October 2013 and applied to forecasted Production / Supplier payment rollforward.
Payroll and Benefits	Forecasted payroll and benefits payments reflects salary and hourly payroll, taxes, benefits and severance forecast. Discussed payments with HR Manager and reviewed prior period run rates to determine timing and amount of payments.
Utilities	Forecasted utility payments are forecasted to be made at the end of each month consistent with historical information and prior period run rates.
Rent	Forecasted rent payments to be made at the beginning of each month consistent with contractual terms and prior period run rates. No leases expected to be terminated in the 13-week period ending October 2013.
Taxes	Tax payments forecasted to be made at the end of September 2013 (end of quarter). Forecast based upon historic information and conversations with Tax Manager and CFO.
Insurance	Tax payments forecasted to be made at the end of September 2013 (end of quarter). Forecast based upon historic information and conversations with Risk Management, CFO and Treasurer.
Capital Expenditures	Forecasted Capital Expenditures to be made for specific projects that need to be completed for new business lines and replacement of roof at US Corporate Headquarters
Professional Fees	Professional fees forecasted reflect prior period run rates, estimates obtained from professionals and contractual terms.
Interest	Forecasted interest payments calculated based on contractual terms.
Loan Amortization	Forecast reflects loan amortization on the Company's term loan per contractual terms at the end of September 2013.
Beginning Cash	Beginning cash balance reflects best estimate of actual cash from Company's ledger and bank balances.
Revolver Availability	Forecasted availability based upon A/R and Inventory eligible amounts with respective advanced rates consistent with prior borrowing bases and per contractual terms.
Total Liquidity	Total liquidity is minimum cash of cash balance of $5 million plus availability under the revolving credit facility
Revolver Draw	Forecasted revolver draws based upon Company keeping a minimum cash balance of $5 million.

1) Crisis Stabilization – Working Capital Reduction

- **Accounts Payable**
  - Detailed review of vendor terms
  - Create a “vendor map” detailing all terms and average weekly spend
  - Focus on opportunities to stretch existing terms and reduce/extend discounts
  - Review disbursement/check-run procedures and frequency of check runs
  - Develop cash management committee
  - Create formal process to review all pending checks
  - Focus on extending payments without disrupting business
- **Accounts Receivable**
  - Perform detailed review of outstanding AR and historical collections activity
  - Search for opportunities to tighten terms and/or extend discounts to reduce Days Sales Outstanding (“DSO”)
  - Create a “customer map” detailing all terms and average weekly sales
  - Understand current Collections’ protocol
  - Focus on motivating AR personnel to collect faster (installation of incentive plans, “spiffs”, etc.)
  - Establish weekly AR meeting to discuss collection plans
  - Create target list for each collector and set specific weekly collection goals

1) Crisis Stabilization – Working Capital Reduction

- **Inventory**
  - Perform detailed review of current inventory on-hand
  - Chart inventory turns by product type (high-level SKU analysis)
  - Search for opportunities to reduce slow moving inventory
  - Review possibility of removing certain inventory and replacing with faster turning inventory
  - Review historical inventory trends
  - Determine which months/weeks turn inventory fastest - and why
  - Shift purchasing patterns to better mirror business cycles
  - Examine purchasing contracts
  - Determine if opportunities exist to return slow-moving inventory
  - Focus on opportunities to reduce inventory costs (potentially via commitments to buy future amounts and or via exclusive contracts)
  - Create Purchase Order ("PO") review process
  - Incorporate purchase order review into AP cash management process
  - Require PO's over a certain threshold to be approved by senior management (e.g. the CFO/Controller)

1) Crisis Stabilization – Asset Reduction and Short-Term Financing

- **Asset Reduction**
  - Capex and Discretionary Spending
    - Stop all Capex pending immediate necessity review
    - Stop all obvious discretionary spending, i.e. “anything new”
  - Sale of Non-Core Assets
    - Cash value of insurance polices
    - Real Estate
    - Excess equipment
    - Business unit/division
- **Short-Term Financing**
  - Meet with lenders to arrange short term agreement on liquidity availability
  - Discuss terms relief with vendors

2) Leadership

- **Begin assessing the CEO, senior management, and middle managers**
  - Obstructive members of management who cannot get past denial must be dealt with.
    - Owner-CEO's must be "led out of darkness and shown the light of reality"
  - Other senior management must be separated into those who understand reality and are not in denial and those that persist with the status quo
  - CFO/Controller function is critical and often must be replaced
- **Action must be taken to build the critical mass of new thinking in the Company to effect a turnaround**

3) Stakeholder Support

- **Appropriate Communication**
  - Lenders
  - Vendors
  - Customers
  - Employees
- **Must Rebuild Credibility**
  - Develop message
  - Communicate . . . Communicate . . . Communicate . . .

4) Strategic Focus – Business Assessment

- **Where are we making money, where are we losing money**
  - Plant by plant analysis
  - Customer by customer analysis
  - Product line by product line analysis
  - Product/SKU by product/SKU analysis

- **Can we trust the cost accounting**
  - Are costs captured accurately
  - Are indirect costs allocated accurately (Not on a GAAP basis) but on activity driven basis

- **What is "Core" business**

- **What is our currently implemented "manufacturing strategy" (plant setup) best suited to produce in the short run. Sell what you can make well – not anything a salesman thinks he can sell**
  - Many products/SKU's added over time but nothing discontinued
  - 80/20 rule on products versus profit

- **Develop action plan to focus business on products, customers, and processes that are profitable**
  - Understand that there are two limited resources: (1) Money, (2) Management time / Talent
  - Focusing money and talent on profitable business rather than wasting it on "continuing to baby sit problems" produces excellent results.

5) Organizational Change

- Revise structure to facilitate accountability and responsibility
- Determine who is both capable and willing to get the job done under new thinking
- Does the management organization promote "Decision Making" or "Finger Pointing"
- Establish efficient compensation/reward system

6) Critical Process Improvements

- **Management Reporting/KPI's**
  - Financial reports that give appropriate and accurate information
  - Timely reports
  - "Period in period" reporting
  - Cost accounting improvement
  - Pricing/Bidding procedure improvement/corrections
  - Strict process adherence
  - Operational discipline – NO SHORT CUTS!

Characteristics of Successful Turnaround Strategies

Two Key Messages – Don't "Chip Away" – Blow It Out!

1) **Firms employing successful profit improvement strategies use almost twice as many profit improvement strategies as firms employing unsuccessful strategies**
2) **"Ruthless" follow-through is required: Need for more rather than less action**

- Some new management is almost always necessary
- Successful strategies are more often characterized by improved financial control systems than are failed situations
- Failed situations often take steps to improve control systems but fail to use the resulting data to implement tight financial control
- Nearly all successful strategies involve focusing resources on selected business units and selected product-market segments
- Cost reduction strategies are frequently used as part of a profit improvement strategy, but are used even more frequently by firms that fail to improve
- Cash generation, particularly via divestment, is a characteristic of most successful strategies
- Improved marketing effort is common to both successful and unsuccessful strategies, but successful firms tend to couple this with more fundamental product-market reorientation
- The most successful strategies include significant organizational change in terms of both organization structure and processes

Characteristics of Successful Turnaround Strategies

- Early and decisive action will lay the foundation for a successful turnaround. Weathering a Corporate Storm Depends on an Organization's Ability to:
  - Face problems early
  - Seek professional and objective help to stabilize core operations and restore credibility
  - Gather, examine, and diagnose the facts at the root of complex operational and/or financial problems
  - Make difficult decisions
  - Plan a clear and executable path forward
  - Forge consensus among polarized factions of internal and external constituencies
  - Lead people into the future with a sense of vision, realism, and commitment

Role of "New Thinking"

A critical mass of new thinking is required within management ranks to lead change throughout the organization.

"The significant problems (and opportunities) we face cannot be solved at the same level of thinking we're at when they were created."

"You have to look at changing the way you think, then the way you act."

-Einstein

Welch's Six Rules

1) Face reality as it is, not as it was or as you wish it were

2) Be candid with everyone!

3) Don't manage, lead!

4) If you don't have a competitive advantage, don't compete

5) Change before you have to!

6) Control your destiny or someone else will