Distress Signals: Advising Companies During Economic Uncertainty

By Natalie G. Rooney

Used to be, business was so good most companies were able to succeed in spite of themselves. "Even for companies that were not particularly well-managed, there was business to be had," says Nancy Skoe, CPA, CFF. Then, times changed. Today, the number of companies in distress is on the rise. They need help from the right people to restore profitability.

Distressing Situations

The two main types of distress are economic and financial. Economic distress happens when a company has poor underlying economics—the idea behind the company doesn't work on a long-term basis. Financial distress occurs when a company has a good product or service but is struggling because of a bad financial structure. Some companies experience the double whammy of both kinds of distress—a bad concept and excessive debt. "We're seeing more of that now than we have in the last 20 years," says **Tom Kim, JD, MBA, CTP**, founder and senior managing director of r2 advisors, llc, which assists distressed companies in developing turnaround solutions. "We're in a phase right now where a lot of companies just have too much debt."

Companies that are distressed are usually experiencing a consistent decline in revenue and profit, are generating negative cash flow, and have insufficient working capital. This may cause them to violate bank loan covenants or be unable to cover payroll, rent, or other critical expenses.

"There is a whole range of distress," says **Steve Emerson,** a vice president with Summit Investment Management, a firm which acquires the debt of distressed companies. Emerson says at the first level of distress, companies may be about to violate bank loan covenants or are making late payments. At the next level, companies likely are not making any payments at all. Finally, a company is on the verge of, or declaring, bankruptcy.

All troubled entities reach a distressed state through a progression of mismanagement — from officers to board members to investors. When the entity is at a precipice, there is opportunity.[1] This is where a turnaround advisor or distressed debt advisor can offer assistance and advice. These organizations can help provide "a fresh, independent view of a company and use their expertise to provide a turnaround strategy or restructuring plan," says **Luke Braly, CPA**, a senior consultant for investment advisory firm FTI Consulting.

Braly says firms like his begin working with companies in a number of different ways. Sometimes a company will be experiencing difficulty and will contact a turnaround advisor of its own free will, while others will be referred from a lender.

Getting Back to Basics

The goal ultimately is for a distressed company to develop a turnaround or restructuring plan to follow and get back on its feet. Advisors suggest taking basic steps to get started. "In a distressed setting, cash is king," says Braly. "Cash is going to be necessary to

implement any kind of plan, reverse fortunes, and come up with solutions to turn the business around."

It may seem like common sense, but you'd be surprised how many companies need to get back to basics and perform a 13-week cash flow analysis to see where they stand, says Skoe, managing director of r2 advisors, llc. "You need to be able to anticipate what's coming."

Other steps include making cost reductions, improving working capital management, and indentifying redundant assets that can be liquidated. "Review all available options to create liquidity," says Braly. "This may include increasing cash flow through cost reductions, improved working capital management, and selling underutilized assets."

"The key is a return to business fundamentals by conducting an objective analysis of the company's performance," says Kim. "Do a margin analysis on products and divisions and make sure each one of them is making money." And if a product or service isn't making money, get rid of it. "There should be no sacred cows," Kim says.

Don't forget to look at the financial health of your customers, advises Skoe. "It's easy to get blindsided quickly." Verify payment terms, stay on top of your accounts receivable and collection activities, and conduct credit checks on new customers, she says. "You should make sure your customers are credit worthy."

Be Proactive with Creditors

Don't wait until it's too late to contact your lender and begin working on a solution, experts advise. Early communication is critical and helps management maintain its credibility. Meeting with vendors and bankers as soon as there's trouble and getting a plan in place as soon as possible are important, suggests Skoe. "Everyone is interested in a successful outcome." Don't wait until the lender contacts you to say it hasn't received financial statements in six months.

Braly agrees and encourages companies to be transparent with their creditors to help begin negotiations. "This adds to your credibility with lenders, and they may be open to alternatives to restructuring debt."

Emerson advises caution as well as proactive communication. "You need to be careful about what you say because there may be remedies that will kick in if the bank believes you're going to break a covenant," he says. "Maintain a good relationship with your bank. Talk hypothetically: 'If we think we'll break a covenant, what would we do?'"

Flexibility may not always spring to mind as a term associated with a lender, but ultimately, banks don't want to operate businesses. "It is not always in their best interest to take over," Braly says. "But, they do want to recover their principal. They may be willing to look at all the options."

A Dose of Realism: The Lending Environment Today

The media is filled with stories about the dire state of commercial lending. If you're looking for new money, don't be surprised if lending terms are vastly different than what they were when you first worked with a lender. Banks are lending, but the criteria have changed dramatically.

"If you've got a bank document that was written in 2006, don't expect the terms today to resemble the terms before," Emerson says. "It will be like night and day. It's just a function of the different lending environment that exists today and a shift in the supply and demand for capital."

Emerson also advises company management to be cognizant of the fact that they need to be concerned about all of the company's stakeholders. At some point, their fiduciary responsibility may shift from the shareholder to the debt holder. Owners become incentivized to take significant risks to salvage a company's value when that might not be in the best interest of the debt holder or other creditors such as employees and vendors. "You could end up in a lawsuit a year down the road, and a court will look at your actions with twenty-twenty hindsight," he says. "Ask yourself, 'if someone looks back at what I'm doing now and things have gone the wrong way, how will this be interpreted?'"

Ultimately, your lender isn't the enemy. "I'm not going to say you should always do everything your lender requests," Kim says. "But you shouldn't always discard what it says either. The lender is an outsider, but typically it has spent a fair amount of time, energy, and human resources understanding your business. Don't get so ego-invested that you can't sit down with your lender and ask what it sees."

The Turnaround Team

Critical to the success of any turnaround plan is assembling the right group of people with the right information at the right time. Based on where a company is in its individual situation, different professionals will be involved. At various points in a restructuring process a team may consist of CPAs, investors, individuals from private equity firms, restructuring advisors, and attorneys who may specialize in certain areas such as real estate or insolvency law. Kim says attorneys play an important role in evaluating the legal possibilities. "You don't want to get nine-tenths of the way through a process and find out you didn't know about something or that an idea isn't legally viable."

Another benefit of getting experienced advisors to help your company through distress is that having third party advisors involved can help maintain objectivity. "Objectivity is critical to identifying feasible solutions. Experienced advisors help to facilitate a professional, positive dialogue which will help resolve the distress, rather than contribute to it." says Skoe. Third parties often see advantages or disadvantages to a particular solution and can assist the company with modifications that will ensure successful implementation of a turnaround plan.

Kim says it's rewarding to help restore a company to profitability, help to save jobs, and overcome the stigma of bankruptcy. "I like the life/business corollary that people don't go through life seeing only sunshine," he says. "If you look at a lot of successful entrepreneurs, you find out they tried and failed at a couple of things before they were successful."▲

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1. John Collard, *"Mining Value from Distressed Companies: Building Properties in Which Future Buyers Want to Invest,"* **The Journal of Corporate Renewal,** Nov. 1, 2006

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