abfjournal

REPRINTED FROM THE SEPT 2012 ISSUE, VOL. 10, NO. 6

TURNAROUND CORNER

Distressed Company Rescue: Identify Problems Early . . . React Rapidly

BY TERRY KOHLER AND NEIL GUPTA

The market decline, economic slowdown and contraction in liquidity over the past five years have led to an increase in the number of businesses regarded as underperforming or distressed. Most business failures can be traced back to problems arising years prior to any corrective action. However, immediately responding to early indicators of distress can provide management and lenders a variety of rescue strategies.

TERRY KOHLER
Vice President, SSG Capital Advisors

NEIL GUPTA
Associate, SSG Capital Advisors

The past five years have been arduous for many companies, especially those in the lower middle market. The market decline, economic slowdown and contraction in liquidity from 2007 to 2009 have led to a large increase in the number of businesses generally regarded as either underperforming or distressed. Furthermore, the sluggish economic recovery has destroyed any management team's expectation of rescuing its company through a general economic rebound. As a result, troubled companies today are faced with the task of confronting challenges head-on.

Anecdotal research shows that most business failures can be traced back to problems arising years prior to any corrective action. The delayed reaction can be caused by either a lack of attention to indicators or the lack of acceptance that underperformance is evident. The business issues, which may seem insignificant at first, tend to escalate into greater future difficulties and turn declining performance into distress. Thus, it is important for companies to rapidly identify and address problems before they are exacerbated.

Identifying Issues

Recognizing the early warning signs that indicate that a company is experiencing problems can dramatically increase the chances of turning around a company. The first place to look is the financial statements. Leading indicators of distress include general sales declines, negative cash flow, stretched account receivables, slowing inventory turns, margin compression, missed projections and breached bond covenants. Beyond the information found on financial statements, it is imperative to also monitor managerial and operational signs of distress. Product and service quality deterioration, changes in supplier terms, sudden departure of key employees or managers and dramatic shifts in strategy could all be indicators of serious condition.

Addressing Problems

The emergence of one or more of these signs is often an indicator that some form of intervention is warranted, before a previously manageable situation grows and triggers further problems. One of the most challenging problems for a company experiencing financial distress is managing the ongoing business as well as the turnaround. Managing the complexities of business distress is not only time consuming, but also requires a specialized skill set. At this point, it is prudent to quickly retain a turnaround firm and an investment bank.

Hiring the right advisors can be an invaluable asset in a company's time of greatest need and is crucial to the survival of a struggling business. These professionals can identify the specific core challenges and the most appropriate solutions from an operational standpoint before the company's condition worsens. Furthermore, outside professionals may be better equipped to accurately project financials, negotiate with creditors and develop an exit strategy.

The management team of a distressed company may resent or resist the added expense of outside specialists when confronted by an already cumbersome financial burden. However, by avoiding or delaying the engagement of a turnaround specialist and an investment banker, chances increase that the company's lenders or other creditors will unilaterally require or force the company to take this step.

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Creditor Relationship

A common mistake is to regard the creditors as adversaries. Investors and management should treat the bank and other senior creditors as partners and cooperate with them to find the most viable strategies to save the company and protect its stakeholders. The worst course of action is to conceal from lenders that the company is in financial trouble or to block attempts by creditors to influence the solution.

Management may instinctively shy away from keeping creditors well-informed because they assume that the financial lenders will expect equity holders to automatically commit capital to the distressed company in question. Creditors justifiably demand to be immediately informed when a company is experiencing significant problems, to be provided

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with timely updates and to see a plan of action that seeks to protect senior lenders and/or bondholders.

When a company becomes financially vulnerable, the role of equity holders changes from being investors to being fiduciaries whose primary responsibility is to maximize recovery for all stakeholders. These include secured lenders, unsecured creditors, customers, employees/unions, landlords and government agencies such as the U.S. Environmental Protection Agency, the Department of Labor and ERISA-related agencies.

Strategic Alternatives

The most appealing method for turning around a company typically involves operational and strategic changes that return the company to profitability. However, when operational fixes are not feasible, five strategic alternatives can be considered to address the challenges of a distressed company. These alternatives can help to limit financial hemorrhaging and perhaps even position all or some of the segments of the company for future growth.

1.) The company can wait and hope that the economy will rebound or that a special event (a contract with a major buyer, a competitor that leaves the market, a breakthrough product, etc.) will save the day. More often than not, this strategy is wishful thinking.

2.) The ailing company can also attempt to attract new financing. Once the company has determined the level of debt that can be privately placed and properly serviced, it can look for a minority equity infusion from strategic investors or others. In this situation, the equity holders and the company's senior management may have to be prepared to sacrifice a significant amount of ownership.

3.)The company can attempt to restructure the balance sheet. This may entail renegotiation of the existing senior and subordinated credit facilities, restructuring of unsecured creditor obligations, restructuring equity tranches that will facilitate a turnaround and long-term recovery, reorganization of the equity base and/or renegotiation of union contracts. A well-conceived restructuring plan or effort can buy considerable time, assuming that the plan right-sizes the balance sheet and/or improves performance.

4.) The company can be sold in its entirety or by division, in order to maximize value to all concerned. A sale is not necessary for a turnaround if operational changes are effective or if the above alternatives are viable, but the ensuing synergies or the availability created from a cash-flow perspective could justify a business combination. Furthermore, this can save jobs and ensure that viable, existing products and products in development do not disappear without an opportunity to find a market and generate revenues.

5.) In the end, total liquidation may be the sole course of possible action. This is the worst outcome for all parties, since liquidation typically provides the lowest valuation to all stakeholders and rarely preserves the jobs of management and employees.

Example of Prompt Action to Sell Company

The recent sale of a poultry processor illustrates the benefits of quick, decisive action in order to maximize value for all stakeholders. The company was one of the largest vertically integrated poultry companies in the world and produced value-added poultry products for customers ranging from national chain restaurants to grocery retailers. Starting in the summer of 2010, the poultry processing industry faced a sharp increase in the cost of inputs such as corn and soybean meal. Furthermore, as a result of overcapacity, the poultry processing industry was unable to pass on the increased cost of inputs to customers. This dynamic negatively impacted the company's profitability and the entire poultry industry.

The company immediately sought the assistance of investment bankers to explore strategic alternatives, including a potential sale of the company. The investment bankers conducted a competitive bidding process and ultimately sold the company's stock to a foreign leader in the poultry industry for a purchase price substantially above liquidation value. If the company had waited to retain an investment banker, the continued industry stress may have forced a bankruptcy filing or liquidation, and the eventual buyer may not have been in a position to proceed with the acquisition. Instead, the company was able to maximize its acquisition value by appropriately responding in a timely fashion.

Example of Prompt Action to Restructure Balance Sheet

Another example of quick reaction involves the refinancing and restructuring of the debt facilities for a commercial printing, packaging and fulfillment company. Its diverse product line includes high-end commercial printing (specialty catalogs, brochures and inserts), specialty products (restaurant menus and playing cards), specialty packaging (blister packs, folding cartons and clamshells) and full-service fulfillment/mailing services. The recent recession had a negative impact on the commercial printing and fulfillment industries with overall budget reductions across the company's client base. Given the resultant impact on profitability along with elevated debt levels, the company sought a means to reduce leverage and strengthen its balance sheet.

It's never easy for an ailing company to recognize and accept its distressed status. However, by immediately responding to early indicators of distress, management and lenders can consider a variety of rescue strategies that will pay dividends relative to delaying action.

The company retained turnaround professionals as well as investment bankers to develop optimal solutions. Working closely with the company's restructuring professionals, the investment bankers were able to recapitalize the balance sheet with a new lender. The advisors were then able to facilitate negotiations among key stakeholders that further enabled the company to successfully restructure its remaining debt and equity. Had the company delayed addressing its problems, it may have defaulted on its debt. The rapid response allowed the company to refinance on competitive terms and maintain value for all stakeholders.

Conclusion

It's never easy for an ailing company to recognize and accept its distressed status. However, by immediately responding to early indicators of distress, management and lenders can consider a variety of rescue strategies that will pay dividends relative to delaying action. As shown by the examples above, acting swiftly significantly increases the likelihood of extracting maximum value for all concerned parties, including management, employees, lenders and other stakeholders. abfj

TERRY KOHLER is a vice president of SSG Capital Advisors. He earned his M.B.A. from the University of North Carolina Kenan-Flagler Business School and B.A. from Dickinson College. He can be reached at 610-940-5808 or *tkohler@ssgca.com*.

NEIL GUPTA is an associate at SSG Capital Advisors. He earned his M.B.A. from the University of North Carolina Kenan-Flagler Business School and a B.S. degree from Johns Hopkins University. He can be reached at 610-940-2663 or *ngupta@ssgca.com*.

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