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"In a death spiral, I would rather have the wrong answer now than the right answer too late!"...cynical words by a case-hardened turnaround guru

By Harry Gray and Chad Greenway

With the deluge of hyper-leveraged buyouts consummated during a period characterized by peak multiples and peak earnings, covenant-lite loans and marginalized credit standards, crisis looms for many businesses in the middle market. All at once, several archetypical restructuring levers used to thwart collapse are haplessly rusted solid, from sale-leasebacks to bridge funding to reduced borrowing-base and collateral value. Meanwhile, exacerbating the entire situation, the outlook on sector growth and global demand is blurry at best. This is a perfect storm!

Portfolio managers, operating executives and advisors who are experienced mostly in stable, growth-oriented settings will increasingly find themselves having to rely more on art and instinct, less on history and analytics. This is indubitable alien turf. Meanwhile, as foreboding distress clouds creep closer, many managers will retreat defensively to reassuring postures, and paralyze the organization with proliferated analysis and reporting surges; but, they will fail to act. These lapses, often committed with good intentions, but by managers with either poor skills or limited experience, are scripture in the annals of corporate turnarounds and financial restructurings.

Benjamin Franklin affirmed that "an ounce of prevention is worth a pound of cure." As well in scenarios of corporate demise, a little precaution before a crisis occurs is preferable to a lot of fixing up afterward. So, before the onslaught of crisis, how can investors and advisors help management with battle planning and advance staging for either a turnaround or restructuring?

- **Create mock covenants reported through KPI format.** In the leveraged acquisition game, what were once investment committee high-fives are now dirty bombs furtively lurking in the boardroom shadows. Many drank an explosive cocktail teeming with cheap money, but lacking warning signs necessary to portend demise. We advocate appending "mock" covenants to the company's KPI reporting data, to include minimum quick and current ratios for liquidity testing, minimum return-on-assets and return-on-equity for profitability testing, and minimum equity, minimum working capital and maximum debt to worth for leverage testing.

- **Learn to operate by cash—not GAAP—and recast signature authorities to tighten operational controls**. Cash pays the bills, and it should be axiomatic that EBITDA is not cash flow and means nothing in crisis. We are always surprised to find how often poor organizational practices calcify into tradition. In the heady early years of an emerging enterprise, processes and controls tend to mature in the wake of the growth curve. As such, when times are good, inherent leakages are not revealed. Tightening these vulnerabilities may be prudent.

- **Identify enterprise-wide stars and duds, and simplify the organization and its decision frameworks.** Across the span of any enterprise there are pockets of inefficiencies and gems of value—it is the natural order of business. Many management teams do not truly recognize "where they make" and "where they lose" money...and time and again they are shocked by the upshot. The exercise of segmenting products, services, channels, divisions, customers, vendors, personnel and other discrete axes is incredibly telling and affords a decisive path for streamlining performance. Even in stable and healthy periods, companies should routinely force rank and grade under- and over-performance. From reporting structures to product portfolios to vendor proliferation, it may be wise to rationalize the organization for prompt chain-of-command response time.

- **Evaluate both customer and vendor health.** Many middle-market companies do not support credit departments. Customer and vendor scoring is an exercise aimed at overcoming analytical myopia, which can severely blur a proper assessment of the company's health. Particularly in mission critical supplier nodes or hyper sales concentration, an imbalance of power can crush a company when it relies too dependently on wounded customers or vendors. The discipline will embed a sustained rigor that helps mitigate both uncollectibility and supply chain disruptions.

- **Assess opportunities to unlock dormant value.** Monetizing latent strategic potential tends to require capital...and often it requires peripheral talent. In the normal course, companies seek growth by creating innovative products, expanding the market for them globally, and making acquisitions to gain market share and create efficiencies. All the same, when faced with commoditization and increased competition, such traditional growth moves may only replace lost revenues and profits. Boards and senior management will enhance future efforts to salvage the enterprise by identifying hidden assets and opportunities along the value chain for satisfying customer needs. These strategic opportunities will afford a path to growth and enhance prospective divestitures.

- **Establish a contingency plan for rechanneling marketing and selling.** Many companies become almost supercilious with lofty strategic goals and fervor for sexy products, particularly with engineering-driven cultures. This familiar hubris presents an overarching challenge to the marketing and sales process, which will experience a long and expensive cycle, even with skillful evangelical promotion. In a crisis, the company might have to rewind to the past and focus on "last generation's products", all in the spirit of shrinking the selling and cash conversion cycles. It may be difficult for entrenched management to consent to this practical stopgap. On the other hand, while being ahead of the market can involve profuse convincing, if the products or services are sticky, frequently the customers can be part of a turnaround solution.

- **Identify the going-rate trajectory...without management bias.** Entrepreneurs are inherently optimistic and insiders often deny problems or retreat vacillatingly. These human realities taint the process of projecting ingenuously the forward momentum of the corporation's performance. The situation is always worse than described. In fact, any one-time glitch may be the tip of an iceberg. Unfortunately, the board often finds out too late. As a practical matter, this validation may be conducted best by proficient and dispassionate

outsiders. Notwithstanding being armed with bona fide projections, the company will remain marooned absent realistic turnaround actions and their respective timing and impact properly gauged.

- **Frank and honest assessment of current management's capacity to lead…not manage…lead.** Frankly, managers with responsibility are not the same as leaders who are accountable. In fact, one mark of the renaissance leader is someone who effectively delegates and trains an organization of subordinates to no longer need him or her as a manager, but only as a leader. These individuals are special and do not grow on trees. As such, they should be acknowledged early on as critical to turning the organization.

- **Educate the board on its fiduciary scope**. When a corporation is solvent, the fiduciary duties of the corporation's board of directors run to the corporation's stockholders and the board's decision-making process is protected by the application of the business judgment rule. When a corporation is insolvent, the fiduciary duties of the board run primarily (if not solely) to the corporation's creditors. In the absence of early warning signs and preventative practices, many companies will slide seamlessly into the zone of insolvency. Directors, officers and any profit-loss managers must understand that navigating these insolvency waters can be tricky and sometimes ruinous.

- **Walk around**. What is ritual in the military context is often lost in the corporate setting. This is perplexing, since there is simply no better way to motivate employees and share vision than to walk around. Because information speeds along the electronic highway in an incomprehensible blur, too many general managers find themselves swallowed by the inundation of virtual communication. The real scoop is contained in the ranks. At the same time, real solutions may also be suppressed. The virtues of walking around are unassailable not only for general managers, but also for board members, investors, advisors, lenders and the like.

This is by no means an exhaustive list, and it would not supersede domain-specific knowledge that drives sector-specific actions. Rather, these few provisions are consistent with the spirit of planning for a different mode of execution. Like air raid sirens, these actions will help condition the organization for habitual response to changes a turnaround leader will in due course impose. The warning signs of demise are many, from the litany of financial ratios espoused in textbooks to qualitative occurrences such as the proliferation of white papers, reports and analyses, the shift in effectiveness and periodicity of employee and management meetings, and pre-mature efforts to go public. Too many grim ratios and foreboding signs might intimate a dangerous nexus of poor strategic and operational health, and eventual progression into the precarious phenomenon whereupon capital costs (i.e., WACC) exceed capital returns (i.e., ROIC). This is precisely when the death spiral's vortex spins faster, and in today's environment, we will indeed see many hard falls.

Our team has been involved in many troubled company situations as C-level operators, distressed investors, troubled portfolio company managers and restructuring advisors. There are indispensable lessons that can only be gleaned from trench combat. Successful hands-on execution, especially in crisis, requires both the art and science of turnaround management. Establishing command and

control in crisis requires much more than unlocking and preserving cash; it requires a unique battle-hardened skill set not typically developed in the course of caretaker careers. Generally, status quo general managers do not operate in venues depleted of capital, talent, reputation and morale. For this reason, many pedigreed backgrounds are incongruous with the grit and grind of running a distressed company. So, what are a few of the prevalent observations, chronic conditions and sage tidbits that investors, advisors and management teams can ascertain from the salty turnaround world?

- Military commanders will confirm that far more learning is achieved from watching troops in battle than from watching them on maneuvers. In this same vein, turnaround leaders can more accurately assess the skills of the people and the needs of the company by observing the organization in action than by poking around the past. Hence, the prescription for improvement is best determined after an initial period on the deck plates.

- Complex situations are best addressed by distilling the alternatives down to binary decisions—to go or not to go. Command decision-making quintessence would certainly be Eisenhower's two letters on the eve of D-Day: he penned both a victory missive...and a resignation. Moreover, attempts to solve all of the problems simultaneously can be forewarnings of amateur crisis management. Successfully prioritizing actions is essential, especially in troubled companies with weak bench strength and waning resources.

- In any given day in crisis management, is often about what to blow off, rather than what to complete. In the stable organization, organizational issues can be considered deliberately. In heightened states of crisis, there is an old adage that "I would rather have the wrong answer now than the right answer too late."

- If the company elects to deploy a Chief Restructuring Officer (CRO) alongside incumbent management, the CRO must be empowered at the board level. Frequently in the middle market, the CRO will find an autocratic and high-handed leader at the helm. These types of leaders tend to be mushroom farmers, keeping their people in the dark and feeding them manure. Hence, CRO deployment must be deliberate, smart and realistic...because ultimately two-headed snakes will self-envenomate.

- In the short term, costs can be hard to negotiate, but the selling price can be negotiable. In many instances, even if legacy costs come down, new costs may increase; in these instances, there will occur an inflection point when aggregate costs go up…you have to factor in and fund this gap.

- Many amateurs let tactical decisions trump strategic rationale. It is not about "best practices", it is about reconstituting "good practices". To exemplify, deploying lean/six-sigma can be pointless...even a blunder...if the revenue umbrella and addressable market are lost. For the business to endure, however, the "good practices" need to be sustainable and every process must have an owner (i.e., salesmen "own" the inventory).

- Management ownership is not equity when it is inconceivable for the ailing company's out-of-the-money strike price to convalesce. In these deeply

underwater scenarios, "ownership" is the factory worker picking up trash when nobody is watching. The worker still has the spirit of doing well and doing right. There are very few secrets that do not end up at the water cooler's "underground" and you have to assume that resumes are on the street.

- When the culture is corrupt, the turnaround may require replacing a key manager or two even if they are viewed as important to the business…if their attitudes are poor or they protect rogue agendas, they must go. In cultural turnarounds, managers need either "fire in the belly" (i.e., like the liter-collecting plant worker above) or "fire on the rump". To this end, an "A" attitude with "B" talent will typically prevail over an "A" talent with "B" attitude. Nevertheless, shifts from "C" to "A" in either attribute are unlikely. In the end, when Rome is burning, it is a lot easier to motivate and train an incumbent with brains than it is to find replacements.

- Recurrently, a viable core business is smaller, but more profitable, than the commencing troubled company. Moreover, from time to time, the viable core business is not the perceived "legacy" business. Nonetheless, with few exceptions, companies tend not to shrink to greatness when aggregate market share declines.

- Beware of the murky under-layers of concentration risk. For example, even if there is no customer concentration, there can still be salespeople who "own" too many customers. Similarly, traditional capacity utilization analysis on a topical basis can mask ensconced constraining nodes and bottlenecks.

Unsurprisingly, there are many more recurring characteristics and troubled company lessons that embody the art of turnaround management. Order and entropy coexist in the turnaround-restructuring ecosystem, and true execution-oriented turnaround management is a highly-specialized field populated by professionals skilled in crisis management, parachute C-level leadership and operational decision making in resource-poor environments. Taking the reins in these venues by and large runs in parallel with complex debt restructuring, distressed divesting and select reinvesting. Accordingly, the anticipatory early actions articulated above can increase the probability of recovery...especially when there is little time to collect, analyze and disseminate data. Conversely, without heeding Franklin's sagacious words, the situation might very well entail "the wrong answer now, rather than the right answer too late!"