Can This Ownership and Management Group Turn It Around?

By Gerald M. Sherman

In mid-1997 a major East Coast bank loaned $20 million to a privately held defense contractor to refinance $11 million in existing debt and make a $9 million acquisition. The bank was successful bidder among six regional lenders competing for the business. In 1998, the company lost $3 million on $42 million in sales. In 1999, it lost $7 million on $52 million. In early 2000, the workout officer managing the loan confided to me his analysis that the bank was about $10 million undercollateralized, an opinion I agreed with.

With the help of my firm, the company began a divestiture program in mid-2000, reengineered the manufacturing practices of its core business unit and, most significantly, replaced two of its founders. At the time, one was chairman and the other was president. This step was possible only because the company, while privately held, had more than 200 shareholders and was ultimately controlled by its board. Over an 18-month period, all noncore units were sold, 70 percent of top management was replaced and gross margins in the core business improved from three percent in 1999 to 22 percent in 2001. In mid-2003, the bank was repaid in full and the company continued to grow dynamically. In September 2004, the company entered into an agreement to be sold for $92 million to a publicly traded strategic buyer.

Looking back, should the bank have known that trouble was coming when it made the loan? And could the bank have had any way of predicting that the company would turn around so successfully?

In November 2000, the same major East Coast bank provided $22 million in financing to a longtime borrower, a family owned contract manufacturer, to construct a new facility focused on meeting the needs of one major customer. In 2001, the company earned $1 million on $50 million in sales, its 34th consecutive year of profits. In 2002, the company lost $20 million on $26 million in sales. In April 2003, it began a voluntary "liquidating" Chapter 11. The bank came out whole (barely) and had to invest considerable time and effort to protect its asset. The family lost its entire investment in the business, and the guarantors were happy just to be relieved of their personal exposure.

What happened? Should the bank have known that trouble was on the horizon? Could the bank have managed the situation differently, perhaps leading to an easier workout for the bank and a better result for the borrower?

What Indicators Suggest a Possible Turnaround?

As turnaround advisor to the first company described above and acting CEO of the second, I came to understand why these companies experienced significant difficulties and why one eventually succeeded while the other didn't. Both of these situations are highly instructive and can provide considerable insight for the lender and, when needed, the workout officer.

Troubled companies almost always reflect troubled management. Further, in the middle market this article is focused on, it is critical to look at both ownership and management together as the team that will drive a company's ultimate fate.

It's not about the economy—almost all of the time! Certainly financial problems can be economically and/or industry driven. Even then, however, ownership/management is almost always responsible for taking the steps that positioned the company to fail during a downturn. After all, even in the toughest times, relatively few companies become severely distressed. Yes, overriding external factors drove situations like the recent collapse of the telecommunications industry. At the same time, while getting considerable attention, situations of

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this type represent a small percentage of total business failures.

This article will explore the critical indicators that can give every banker an expanded understanding of his or her borrowers. In acting as turnaround advisor to more than 400 companies since 1983, I have found that these characteristics and practices point to the likelihood for severe difficulty and, conversely, the possibility for a successful turnaround. Because my experience has been almost exclusively with middle-market, privately held companies, my comments are limited to this business segment.

The Bank/Borrower Disconnect

Traditional credit analysis is focused on balance-sheet ratios, the adequacy of historical earnings compared to future obligations and an assessment of asset values. On the other hand, a company's future performance and long-term creditworthiness is the function of a much more complex set of variables. Accordingly, there can be a major disconnect between how a bank rates a loan at a point in time and where the borrower is, in reality, headed. Further, this disconnect can be exacerbated by two simple realities. First, most banks want to grow their loan portfolio. Second, many corporate borrowers focus their energies on borrowing more money even when they would be better served to focus on other means of improvement.

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For example, I recently worked with a client that had increased its line of credit six months previously with the asset-based lending group of a major New England bank. While the company must have met the credit criteria of the bank when the increase was approved, it had to have been at the very low end of that scale. Further, at about the same time the increase was under consideration, the company lost a major customer, *a fact the bank became aware of before giving its approval.* To the bank's great disappointment, the company incurred losses of about $600,000 on sales of $15,575,000 in the first six months after the line increase was in place. Not surprisingly, within the first four hours of my working with the company, significant ownership/management issues became apparent. Most particularly, ownership/management was not able to react effectively to business challenges due to a diffused ownership structure in which nobody could make major decisions. Further, the process for making decisions at the board level was slow and often based on self-interest rather than the needs of the company. Could the bank have identified this issue before approving the line increase? My answer is a very clear "yes." Should this have altered the decision? Not necessarily, although, in hindsight, that decision would have been to the bank's advantage.

Evaluating the Borrower's Capabilities: A Structured Approach

Despite a visceral understanding of management's importance, I've never seen lenders use a consistent, structured approach to assessing a borrower's capabilities. By contrast, fundamental credit analysis always examines the same basic measures: cash flow coverage, debt to worth, profitability, asset values, *etc.* When I first begin working with a client, one of my first goals is to assess ownership/management's ability to contribute to a turnaround or even simply to an improvement in performance. Depending on the circumstances, the client is often unaware that I'm making such an evaluation. Further, I believe that bankers could use the same basic techniques in their evaluation of troubled companies (as well as borrowers that are rated satisfactorily).

The indicators I've identified and my techniques for learning about them are based on experience, not any form of rigorous research. Nonetheless, I believe they are very useful. My indicators fall into two general areas: first, planning and execution and, second, ownership/management dynamics. To get at these indicators, I talk with multiple members of management whenever possible and probe with the series of questions listed below. The circumstances of each company will always present additional areas

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for investigation. The lender should follow those leads wherever they go, as best as he or she can.

Planning and Execution

- Does the company have an annual financial planning process?
- How is the planning process undertaken?
- Does the plan include the profit and loss (P&L), cash flow and balance sheet?
- Does the company have a history of performing within reasonable parameters, plus or minus, against the plan?
- Are sales generally projected high, low, *etc.?*
- Are margins projected high, low, *etc.?*
- What is the long-term history of company profitability?
- Has the company's debt-to-worth ratio improved over the years?
- Has the company's current ratio generally improved over the years?
- Has the company had a history of chronic or periodic cash problems?
- Does the company have a history of meeting or missing timetables it establishes for various business initiatives?
- Does the company have a history of establishing goals that never get accomplished?
- Has the company made the capital investments needed to maintain competitiveness?
- Does the company generally deliver its product or service on time?
- Does the company have a history of quality issues with its product or service?
- Does the company have a history of responding to internal problems in a timely manner? To external ones?

In the area of planning and execution, I'm looking at several broad themes. First, I'm trying to assess if the company has a process capable of producing a functional plan. In particular, I'm looking to see if the company has the ability to assess and project realistically future activity and cash availability. Second, I'm looking to see if the company has demonstrated the ability to establish and accomplish goals, whatever they may be. Third, I'm assessing if the management has focused on the development of financial strength and good liquidity. Obviously, if the company doesn't have a valid planning process, doesn't fully recognize the need for financial strength and can't establish and meet goals, a lender has to have serious concerns. I should also note that I've included financial issues as a part of planning and execution, because I'm trying to assess management's ability to plan and execute their financial goals over a number of years, not just at the point in time that credit analysis focuses on.

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Ownership/Management Dynamics

- Has there been regular turnover within the higher levels of management?
- Has there been any change in higher levels of management for over 10 years?
- Are family members trained for the management positions they hold?
- Have family members worked at other companies for five or more years before entering a family business?
- Is there an organization chart?
- Are there job descriptions?
- Are there annual reviews?
- Is the performance of family members measured by the same standards generally used with non-family members?
- Are there annual goals and objectives—both for the corporation and for individuals?
- Are chronic underachievers terminated or reassigned when necessary?
- Are there regularly scheduled staff meetings?
- Are lines of authority clear and respected?
- Is there an active board of directors or advisors?
- Are there regular training efforts to grow the skill sets of management?
- Is there an established and respected governance process?
- Are decisions made on a consistently timely basis?
- Can management and ownership accept and act on outside advice?

In the area of ownership/management dynamics, I'm working to develop a general sense of how

management functions in two fundamental areas. First, I'm trying to determine if ownership/management has a long-term commitment to developing the capabilities of its staff. Second, I'm trying to determine if ownership/management has installed basic management practices that can lead to satisfactory long-term financial performance.

Identifying Seeds of Future Problems

Probing in the areas detailed above will always lead to the development of meaningful patterns. For the troubled company, the only question is where the problems lie. Across the spectrum of acceptably rated borrowers, probing in these areas will almost always help to identify companies where the seeds for future problems have been sown. It's important to note that judgment is a crucial part of this process as neither the issues nor the answers are black and white. Further, the process of probing in these areas is imperfect for many reasons, including the fact that access to multiple members of management may not be available. In those cases in particular, there's a much greater likelihood of getting a very slanted and myopic presentation of the situation. Nonetheless, I've found that very instructive patterns will always develop.

Does the company have the ability to assess and project realistically future activity and cash availability?

Can This Troubled Borrower Make It?

Real judgment comes into play for the lender when the problem loan isn't clearly driven by external forces. In those cases, management's capabilities or lack thereof are crucial. Even in cases when the bank has recommended that a consultant be brought in to advise the borrower, it should be assumed that ownership's/management's capabilities will ultimately drive the situation. The consultant can only achieve so much. Sometimes, the consultant faces outright resistance. Sometimes, the company can neither execute nor realistically afford the level of outside assistance needed. Sometimes, it's just too late. The challenge for the lender is to assess the situation as quickly as possible in order to make the soundest, most timely decisions possible. The two broad indicators discussed—planning and execution and ownership/management dynamics can greatly inform a lender's decisions about the potential direction of a troubled borrower. Assuming that there is both some time and some financial resources to work with, my experiences have taught me over and over to look at four factors in particular:

- Will ownership/management accept and act on advice from outsiders?
- Will ownership/management make tough decisions in a timely fashion?
- Will ownership/management replace nonperformers detrimental to the turnaround effort?
- Is the ownership/management team minimally competent to perform needed tasks until changes can be made?

Referring back to the two situations discussed at the outset of this article, the key to the successful turnaround was removal of the two incumbent senior executives. The decision signified reempowerment of the board of directors and their willingness to make enough of the really tough decisions. In the second case, when the company was eventually liquidated, the key was ownership's total unwillingness to accept advice about changing how the business should be structured and run. Taking this one step further, I would suggest that the lender could have made a solid and quick assessment that there was little chance for a turnaround in that case by understanding the issues and ownership/management's total resistance to change.

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Keep Learning About Your Borrower

Because of the fundamental disconnect between lender and borrower, the lender needs to continue learning as much as possible about the borrower's capabilities. To do so, a structured approach to making assessments in the areas of planning and execution and ownership/management dynamics should help the lender enhance his or her understanding of every borrower. Using this type of assessment process, when a borrower becomes financially distressed, the lender will be in a far better position to evaluate the chances for a turnaround as well as make the best decisions possible about how to recover their asset.

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