Pathway Advisors LLC
Management & Financial Counsel

Getting it Done

Financial and Management Insights for Business Professionals

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Dear Gerry,

I feel very fortunate to have worked over the past several decades as a business advisor to numerous underperforming and financially troubled owner-led and family-controlled companies. Often this work has been frustrating. At the same time, the gratification I've received from my successes has made these efforts well worth it.

There has been one constant in every assignment – I always learn something new! Of real meaning, these experiences have allowed me the opportunity to develop a firm grasp of the reasons why a potentially very good company goes astray. Furthermore, over time I've developed a proactive diagnostic process for identifying early warning signs of financial distress ahead.

In today's newsletter, I'll be spelling out this process for you.

As always, I invite your questions and comments and thank you for taking a few minutes to consider my thoughts.

Hope to see you soon (in person),
Gerry

Identifying the Earliest Warning Signs of Financial Distress Ahead

A Diagnostic Process

Background

After moving from my job as an Asset-Based lender for a major regional bank, I founded a financial and management advisory firm. My first major assignment was to assist a successful thirty-year old family business obtain its first significant term loan. The company had recently been taken over by the founder's son - a salesperson through and through. We raised the financing and then a year later he brought me back in to arrange a line of credit. Again, we succeeded. About two years later, though, he called in a panic. This time he asked me to help him decide if a Chapter 11 made sense. I was a little shocked but not surprised. I had seen warning signs of trouble flashing brightly and discussed them with the son early on. Most particularly, he didn't use the plans we presented to the bank or develop his own when I wasn't assisting him. Second, he paid little attention to developing a truly capable team, or the systems and processes, needed to support growth. Furthermore, discipline and accountability were painfully lacking company wide. Eventually, a Chapter 7 was filed.

About a year later, I was asked to assist a company that had moved into the problem loan department of my former bank. The founder was a hard worker, though very change averse. Nonetheless, over 20 years he had built the company into one of the two iconic home goods retailers in his mid-sized New England city. When the "big boxes" took hold, sales declined precipitously and after years of profitability, persistent losses ensued. When I arrived, it was easy to identify warning signs that the owner just hadn't understood. There was no financial planning or analysis in place; little in the way of clear operating processes; the owner was a micromanager and the company's culture was flat out detrimental. We started by developing solid financial and operational plans and eliminated three unprofitable departments. Subsequently, we rebranded and renovated the store, and brought in a coach for the entire family. In particular, I focused on helping the owner become less of a meddler. After about 18 months, the company regained profitability and we were able to refinance with a new bank shortly thereafter. Fast forward fifteen years and the owner was ready to retire. As a single location retailer, though, there wasn't a market for the store. As a result, we ran a successful liquidation sale that paid the creditors in full and generated a meaningful surplus for the owner. Further, the real estate housing the store was sold quickly and successfully (to my surprise). He's enjoyed a very comfortable retirement and was even invited to join the board of a local bank.

There is one negative to the story though. I'm certain that if the owner had acted more quickly, he would have walked away with at least $500,000 more in his pocket.

With these and other experiences, I came to fully appreciate that the earliest warning signs of trouble are largely about management, not finances. This point of view has guided my work ever since.

My Eight Step Diagnostic Process

Over the years I've identified eight *non-financial, management focused* areas that I proactively examine to identify significant early warning signs. Regardless, I begin every engagement with a thorough scrub of financial and operational information. This guides my initial focus on pressing financial issues: cash flow, bank and creditor issues, getting back to cash breakeven, and putting plans in place to regain profitability.

This effort also provides me with valuable initial insights into key warning signs that the management team had neither fully appreciated nor addressed adequately - if at all. Subsequently, I focus on these eight areas for the purpose of fleshing out my strategies for implementing lasting improvements.

1. Human Capital Development

When I go into a new client, I'm evaluating human resource practices from the get-go. One of my most important and standard questions early on is "How many hours have you spent in the past 24 months involved in formal, professional training."

It's remarkable, but not surprising that for companies heading the wrong way, *the answer is virtually always zero for both ownership, and senior executives.* The problem here is twofold. First, leadership has to continuously grow their skillsets in order to compete successfully. Further, leadership always sets the tone. If they're not interested in learning, it's likely that a substantial percentage of the workforce won't be either. In the long run, this always catches up with a company.

2. Organizational Clarity

An organization just can't perform to its fullest capabilities if the workforce – starting at the top - isn't clear about authority and communications structures. Further, I examine other areas including company-wide accountability and discipline practices, clear job descriptions and regular performance reviews.

I've come to consider the quality of job descriptions and the consistency of performance reviews to be particularly revealing. It's just irrational to think that any member of the workforce can perform to their fullest if they don't fully understand what's expected of them and how their performance is being evaluated.

3. Financial and Operational Planning

The wise man Yogi Berra, said "Without a solid plan, even the most brilliant business can get lost." This is one of the most common failings of a company heading into, or already in a bad place. I evaluate a company's planning practices by asking for the last three years of a company's financial plans. If performance has been way off projection consistently, or the company simply doesn't have a plan, I know something is wrong. Further, when a company's plans display no real emphasis on building Balance Sheet strength, any bad vibes I already had just multiply.

4. Financial and Operational Reporting

If a company can't generate timely, accurate and robust reporting, they can't possibly adjust when essential. You simply can't run a company effectively when you're in the blind. It's not more complicated than that.

5. Change Orientation and Management

Virtually every distressed company I've worked with has had substantial issues with respect to change. More often than not, the issue is a flat-out aversion. On the flip side, the poor execution of change initiatives is very common as well. And these execution issues can hamper a variety of areas beyond product offerings and marketing efforts. Many companies fall behind with respect to the outdated systems and/or equipment as the result of resisting change.

Looking at the other end of the spectrum, it's important to note that changing too rapidly or haphazardly is both common and always destructive.

6. Teamwork

An organization simply can't function efficiently if there isn't a thoughtful meeting structure, effective coordination of efforts, and the consistent encouragement of team efforts. Without these factors in place, how can teamwork possibly develop and fully support a company's on-going successes?

When teamwork is lacking, I often get reports from employees, and even upper-level management, about being taken by surprise repeatably. It's a tell-tale sign.

7. Culture

You might think that this would be hard to get to get a handle on. It's a challenge but far from impossible. And no doubt, it's crucially important to understand. I ask about morale and turnover, if people feel in the loop and if they feel valued. As much as anything though, I look for the raised eyebrow, the somewhat pained groan, and the overall tone of discussions. Sooner or later, I can develop a good feeling about a company's culture and its impact on the workforce.

8. Leadership

You might find it somewhat surprising to know that I've left a *full* consideration of leadership, particularly the CEO, to the end of my analysis process. If I've already spotted a large number of warning signs in the course of my examinations, I know the answer.

And it's just common sense, no company can avoid problems and have a chance to capture its true potential without solid leadership at the top. When I see significant issues, my initial efforts to foster improvement are focused on enhancing leadership team coordination; accountability and discipline; coaching in areas of particular weakness; and on-going education.

Final Comment

Years ago, I was talking with the former president of the Massachusetts Society of Certified Public Accountants. I asked him what he viewed as early warning signs of financial issues ahead. His answer was losses. Clearly this isn't a warning sign, it's real-live distress.

My message here is twofold. First, non-financial issues are, far more often than not, what drives a company down. Second, a focused examination, either proactively or retrospectively, of the eight areas I've detailed will provide an irreplaceable input to understanding where and when fixes are needed.

Think about this process as the business equivalent of a doctor's basic physical examination. You want to know what's OK. But to get a company healthy short and long-term, it's essential to fully understand where the warning signs are pointing and address them both strategically and aggressively.

For more information, contact Gerry Sherman at gsherman@pathway-advisors.com or visit our website pathway-advisors.com

***Pathway Advisors LLC* is a specialized business advisory firm focused on helping our clients effectively resolve the most significant of profitability, cash flow, banking, operational, and organizational challenges. We pride ourselves on the ability to analyze issues quickly, develop plans to solve them efficiently, and leverage our deep relationships in the financial and business communities to do so.**