

When the going gets tough...

Talking to the turnaround professionals

The law of averages will not be denied. As the torrent of cash pouring in to private and public equity deals breaches the floodgates of long-term sustainability, business failures continue to rise. The degree of leverage increasingly applied to such deals only adds to the probability of lending defaults.

Business optimism is fragile. Once dreams of conquest turn to dust, nervous investors pick up the phone. Chief Restructuring Officers, aka turnaround experts, are the Red Adairs of the commercial arena. Extracting a business phoenix from the flames of extinction demands a level of authority, experience and resilience possessed by few.

CROs are an individual breed. No-one wants them; they don't care. Travelling hundreds, often thousands, of miles each week to spend their days in organisations that invariably resent their presence, operating under levels of stress that would crush mere mortals, and receiving scant support from a dispersed peer network, the life of a turnaround professional demands singular skills and a bullet-proof mindset.

Bob Ellis and Paul Felton-Smith are two of the best. Bob brings three decades of change management expertise to the service of distressed organisations. Currently charged with reversing the fortunes of a billion-dollar automotive components group, Bob has taken the helm of public companies in the UK and US, delivering outstanding results in recovery and business improvement scenarios.

Paul Felton-Smith has over 20 years of financial and management expertise across industry. A key contributor to high profile projects at British & Commonwealth, Aspreys and Eurotunnel, Paul has a unique insight into the implementation of reorganisation strategies at the heart of corporate turnarounds.

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'There are many reasons that companies get into distress,' Bob suggests, 'but the common theme is that they can't service the debt. Liquidity is an issue, cash is running out and covenants have been breached.'

'You rarely find good businesses in good markets with poor management. That's not normally the issue. Something has happened; there has been a series of actions that have caused even a good management team to be unable to cope.'

'In some cases, markets have moved against them. In the automotive industry, for example, contracts rarely allow you to pass on raw material price increases to the customer. A whole host of businesses that were marginally profitable have now become marginally unprofitable.'

'One thing that I always find,' adds Paul, 'although management may have good management accounting systems in place, and this is particularly the case in groups, the directors have no idea about their legal responsibilities.'

Several other themes also appear to be universal. The primary attribute claimed by most management teams is growing the business; navigating their way through a downturn by managing cash maybe outside their skillset.

Implementation may also be an issue. Great ideas do not, of themselves, create an enduring business. Poor execution leaves behind a debt without the revenue or margin to service it.

Hitting the ground running

Turnaround specialists are usually called in by a bank or private equity house that has lost confidence in the existing management team. And so begins the ritual dance of negotiation, posturing and positioning, a process that may take months the company doesn't have.

Officially, a CRO must be appointed by the company itself. In the real world, as in the case of Bob's current undertaking, his appointment was a condition of the bank agreeing an amended facility.

'You always go in later than you'd have liked,' Paul agrees. 'There will often have been a period of wishful thinking with banks and other investors keeping their fingers crossed and hoping for the best. Management may be in denial about the need for someone to come in and there is invariably a degree of resentment.'

'No-one is saying "here comes the knight in shining armour";' laughs Bob. 'Although you have a bank hat on, you are also joining a management team and need to work with them. The way to build acceptance is by demonstrating you will add value to the business.'

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Information can be a mixed blessing. The standard Big 4 business review, often prepared at the behest of investors, will usually have taken months to prepare. By the time the review is presented,

it is several months out of date, has occupied vast swathes of management time, swallowed large chunks of dwindling resources and added little of value.

CROs tend to hit the ground running. Competition for roles is limited ('I don't think I could write you a list of 50 people in Europe,' muses Bob 'who could do large, complex, multi-jurisdictional restructuring,') and the new man in charge will have been brought up to speed long before his first day at the helm.

'The first thing is survival,' stresses Paul. 'There is no point having a great plan for your business in year 2 if you can't get through the next 6 months. The cash issue is critical and that has to be stabilised.'

'Typically what we'll do is a forecast for the next 13 weeks. In order to get that accomplished, you have to understand what the business does, how it generates cash, where the pressures are and how you can manage them.'

'What you are doing most of the time,' stresses Bob, *'is buying time*. The banks may work with you by providing some sort of temporary facility but they may not. The most difficult thing to get in these circumstances is new cash. Someone in the bank has to go back to their credit committee and justify putting more money into this thing when it looks like we might lose all of it anyway.'

'A lot of what we add in the initial stages is familiarity with the processes. We know the way this thing needs to happen and how to manage the expectations of banks and the owners. It boils down to confidence. You've got to get the banks into the confidence zone by demonstrating that you understand the situation and how to deal with it.'



Meeting short-term funding requirements may require fresh attitudes and uncomfortable conversations. Instead of quarterly board meetings, Bob Ellis puts the directors on notice that they will be summoned on an 'as and when' basis. Paul Felton-Smith encourages frank discussions with long-suffering creditors and a re-energised approach to chasing up debtors.

The anxiety of internal and external constituents, and the time taken to placate each stakeholder group, provides a considerable drain on resources. Reducing what he terms 'internal noise' is an absolute priority for Bob.

'One of the first things that I do,' he suggests, *'is develop a communication strategy*. You've got financial stakeholders, customers, buyers, employees. You need to decide what you are going to tell them and communicate on a consistent basis.'

'It is no use relying on managers to interpret complex messages. We provide scripts for employees, scripts for customers, scripts for suppliers – and train people to deliver them. I tell all stakeholders, come what may, we will communicate with you on a given date. Even if little has changed when that day arrives, people know they will be told something, which stops them worrying.'



Putting in... getting out...

'One of the biggest bones of contention,' notes Paul, 'is incentive and retention packages. You often find a management team that has performed far from brilliantly is given valuable incentives to keep managing the business, which can be quite irksome for the non-executive directors who have watched these people run the business into the ground.'

Everyone finds it difficult – the board, the banks and you – but it is actually imperative'.

Most CROs are also incentivised. Beyond a day rate, a CRO package will normally include incentives based on predetermined KPIs. This wasn't always the case. Barely a decade ago, few CROs took the incentivised option lest the mess that awaited them was even worse than feared.

Another recent phenomenon is the advent of a distressed debt market. Trading the debt has given the banks an alternative exit route. Whether they take it may depend on how far the loan has already been written down.

'If you go to a bank,' argues Paul, 'and say "here's where we are. We are in breach of covenant, we can cover interest payments but can't repay any capital element of the debt though we do have a plan to re-engineer the business, restore profitability and pay you back in four years' time," most will say no.'

'The banks are tired. They've been let down by this business time and again and they've had enough. If they can get out quickly, they will.'

'The distressed debt market helps to an extent,' Bob interjects, 'as banks may find a route out by selling at a discount. If they were hoping to recoup 80% in 2010 and a debt trader says "I'll give you 62% now", it can be tempting.'

'From our perspective, you are now dealing with a different constituency of creditor – a vulture hedge fund with a much tougher attitude towards getting its money back. If your debt is then syndicated, you may find yourself talking to lots of new people, all with different ideas about what you should do.'

'A friend of mine who was working with four banks on a Friday was summoned to a meeting the following Monday. He found 52 new debt holders in a room waiting for him! The previous holders had traded out and the new arrivals hadn't even read a copy of the accounts!'

Assistance from investors is unlikely. By the time a CRO is engaged, investors have usually written off any remaining financial interest in the business. Maintaining their involvement as directors may be useful if instruments or loan stock demand conversion but practical support must emerge from elsewhere.

A network of specialist expertise

No CRO can reverse the fortunes of an ailing business by themselves. Adding permanent staff is inappropriate at a time of transition but additional resources will be needed.

'There are three areas you are likely to be short in,' Bob asserts. 'The finance department is rarely geared up to provide the quality or quantity of reports that are required. HR must suddenly deal with a whole new raft of people issues overnight and I think there is also a need for an in-house legal resource. Constantly reaching for outsiders is costly and hugely time-consuming because you need to manage that process.'

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'Interims offer a better solution all round,' indicates Paul. 'Working with specialists with the capacity to step into complex environments and take some of the weight off your shoulders is essential. They provide a rapid

injection of energy, skills and experience, which is just what you need with dozens of projects running at the same time.'

Paul and Bob both belong to The Society of Turnaround Professionals, an organisation that seeks to promote a broader understanding of the profession. The STP provides a range of networking opportunities that are essential to future employment. The intensive nature of the job increases the difficulties of maintaining the very contacts on which members depend as a job begins to wind down.



A natural conclusion

'There is a natural point of exit,' Paul declares, 'though it does vary in each case. You've done the restructuring, made sure things are stable, formalised bank support and recruited new management. Having worked with them for a while, it's usually time to move on.'

'There is a danger in staying too long,' Bob concedes. 'I spent 5 years in the States on a turnaround, grew the business successfully and was sorely tempted to stay put. Then I realised it wasn't what I was good at! Restructuring and developing a business are completely different skills.'



'And then it's back to the network. I think of it a bit like walking down the street and seeing a series of bus stops. You can be standing by a stop and three buses will come along at once – you have to decide which one to get on. If you keep on walking, it may be a while before you see one again.'

Economic forecasts suggest such buses will be plentiful in the short term. One organisation has even approached Bob about making himself available on a standby basis – joining the board of a company that may or may not have an issue and pencilling out one day per week in his diary just in case.

Mitigating against the predicted rise in distressed situations, lenders are bending over backwards to relieve the pressure by pushing the tail backwards. Many agreements now include double default provisions. A covenant that must be broken twice before any breach is registered buys most defaulters a quarter or more.

Cure breaches allow private equity investors to provide further funds by way of repair. Even multiple cure provisions are often incorporated, carried over to future time periods if unused.

'We are already seeing the Big 4 setting up specialist turnaround capabilities within their firms (such as Deloitte with Aaronite Partners), and it is likely that most turnaround specialists will be working for one of the Big 4 over the next few years,' Paul suggests. 'People do like brand names. You will see a lot of the services we provide being supplied by the so-called Big 4.'

'In the short term, I'm not sure we'll see as many defaults as widely predicted. Private equity investors have their faults but one thing they are really good at is monitoring their investments. I think they have learned that getting in earlier is a way of averting problems. Realistically, the business may still need a turnaround on a less formal basis to cure the underlying problems.'

'I wouldn't say what we do is enjoyable work,' Bob concludes. 'It is a hugely time-pressured, intensive function that involves working on dozens of different projects at the same time, often with people who may not want you to be there.'

'What makes it all worthwhile is the execution'

'I spent 3 years as a management consultant but left because you never got to do anything. Three quarters of what I do now is the same – all the analysis and consideration – but now I make it happen. What makes it all worthwhile is the execution.'

