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TURNAROUND MANAGEMENT: Primer for Leasing Companies

When businesses get into unfamiliar waters, when outside forces threaten the profitability and even the existence of the company, it's time to call the turnaround manager. And it's traditionally the credit provider—that is, you, who is frequently the impetus behind the decision to get help for the company.

By Howard Brod Brownstein

Time was when leasing companies didn't think about turnaround management. Lease rates more or less tracked asset values, especially after the first year or so. Residual values were sensibly calculated, and the resale market for equipment coming off lease or (perish the thought!) repossessed from a default, was reasonably robust.

Leasing companies were essentially renting money, but in the form of fixed assets. Interest spreads were decent. The tax man had left enough juice in the orange to make leasing beneficial for a variety of users. Life was good. Who needed turnaround management? Things turn sour, just repossess the asset, cash out easily in the used equipment market, and find another customer with better credit. No problem.

Things have certainly changed! There are lease rates and interest factors all over the map, with more competition than ever from financing sources trying to beat single-digit returns on capital. Residuals have been set—shall we say “optimistically”?—only to encounter later a used equipment market that is in free fall. How many “Alert!” bulletins have you received from your friendly neighborhood appraiser/liquidator? And re-replacing the defaulting customer with a better one? Get in line! The credit worthy customers can dictate their own lease terms and if you won't accept them, your competitor will.

So working things out with “the devil you know” may be

the best alternative under the circumstances. But how do you do that? After all, you're not really set up to be a hands-on credit organization like a commercial bank. And you may be located hundreds or thousands of miles away from your customer. What do you do?

Welcome to Turnaround Management 101. As such leading leasing organizations as GE Capital and Tyco Capital know, lease finance is just that—another form of secured finance, to be approached no differently than asset-based lending. That means being prepared to manage through a downturn with your customer by staying close to the situation, being proactive and being part of the solution.

Now, if you're GE or Tyco, you are fortunate to have a phalanx of regional credit officers scattered throughout the country who don't faint at the sight of blood. But what if you don't have that luxury? Or even if you do, there's a limit to how much time you can spend on one account, when all of your credits are “slipping”.

Enter the turnaround manager. When businesses get into unfamiliar waters, when outside forces threaten the profitability and even the existence of the company, it's time to call the turnaround manager. And it's traditionally the credit provider—that is, you, who is frequently the impetus behind the decision to get help for the company. Because let's face it, all of your troubled customers are located in the same place: “Denial”.

So be prepared to insist that, in exchange for your con-

tinued support or forbearance, your customer must accept outside help. Many credit providers give their customers a list of qualified firms from which to choose, since to make the choice for the customer could expose you to lender liability or equitable subordination.

Here is a brief description of what turnaround professionals do, when to call them, and what they can do for your customer.

The turnaround profession is several decades old, and consists of firms ranging from sole practitioners to whole departments of the Big Five accounting firms. The country's leading turnaround firms are recognized each year in *Turnarounds & Workouts*, a publication of The Beard Group (www.beardgroup.com), which lists the "Top Twelve Turnaround Firms".

The best turnaround firms are active in the Turnaround Management Association (the TMA's website is www.turnaround.org), a national organization with nearly five thousand members including turnaround professionals, attorneys, lenders, appraisers, and other key members in the turnaround community.

Among the most prominent turnaround professionals are the 200+ "CTPs"—Certified Turnaround Professionals—who have demonstrated their career commitment to the turnaround profession. They have five or more years proven experience in turn-around management consulting, have undergone a rigorous background and reference check, and have passed a comprehensive exam covering management, finance, accounting and law. CTPs are required to maintain their skills through a demanding continuing education requirement. And perhaps most important, they subscribe to a Code of Ethics which requires them to exercise independence, candor and confidentiality, and many other requirements, in all their client engagements (visit the website of the Association of Certified Turnaround Professionals at www.actp.org).

True turnaround managers are not general-purpose management consultants, and lessors should be wary of consulting firms that "dabble" in turnaround management. The turnaround professional is a specialist—akin to a surgeon—who focuses on the rapid analysis and treatment of business problems and, if possible, the early restoration of profitability.

In many cases turnaround professionals act as advisors to a management team that remains in place. In such cases the turnaround professional typically reports to the Board of Directors, with her daily contact being the CEO, COO or CFO. However, turnaround managers can also be hands-on interim officers of the client, sometimes referred to as "crisis managers". The role of the turnaround professional and the scope of her services, as well as how fees and expenses are handled, should be governed by a written engagement agreement that is reviewed by the client's counsel.

The turnaround of a business is a process, not an event. It typically proceeds through several stages, although these may overlap. Below is a "Turnaround Matrix" which depicts

the steps which often should be followed.

Turnaround managers are sometimes incorrectly depicted as solo John Wayne types. In actuality, the turnaround professional's first task is to assemble a turnaround team utilizing elements of the client's top management as well as his own firm. But the image of the U.S. Marshall of the Wild West is somewhat accurate in that the turnaround professional may have to weed out managers who are resistant to the need for change.

The next task of the turnaround professional is "situation analysis". He must confirm the company's viability by answering, what core business(es) does the company have? Which are or could be profitable? What organizational and financial resources are necessary to sustain such viability and profitability? Are those resources available, either within or from outside the company?

The answers to these threshold questions result in a strategic decision: either the problem can likely be fixed, or an exit must be found. Most experienced turnaround professionals prefer to formulate a turnaround strategy that will enable the company to survive and continue its independent existence, and not be forced to seek refuge in a sale, reorganization or liquidation. But turnaround professionals are not advocates; they will not recommend whatever plan management favors. Rather, they must be objective, and if an exit strategy is what is really needed, a turnaround professional will so advise the client.

A key tool used by turnaround professionals during the early stages of an engagement is a rolling cash flow projection. This is a bottoms-up forecast of cash sources formulated on a weekly basis, depicting the next thirteen weeks of operations, and is typically updated every four weeks. A "base case" projection is initially constructed which shows the trajectory that the company is currently tracking.

All too often, this reveals that the business is on a "Thelma & Louise" course-headed for an abyss and accelerating all the way; that is, running out of cash. Various scenarios are then constructed by the turnaround professional which take into account emergency actions that could effectively move the "wall" farther away by generating and conserving cash. The purpose of these actions is to buy precious time in order to determine and effectuate the longer-term changes needed to restore profitability. The rolling cash flow projection becomes a "road map" by which course corrections are made continuously as information unfolds. If the situation worsens, it can be recognized as early as possible.

A central role played by the turnaround professional is dealing effectively with the constituencies whose support is critical to the company's survival: lenders, suppliers, customers, employees, shareholders and even government regulators and tax authorities. While the company's relationships with some or all of these groups may have become strained, the turnaround professional can frequently persuade everyone that—with her turnaround firm's help and their cooperation—the company has a reasonable chance to be once again the good borrower, customer, em-

ployer, supplier and taxpayer it once was. Since the turnaround professional is objective and not an advocate, her credibility is "on the line" every time. The turnaround firm may be well acquainted with these other constituencies and/or their counsel, and so these otherwise frustrated stakeholders will likely view the turnaround professional's arrival on the scene as a positive and welcome move.

Once the business appears to be stabilizing and the key stakeholder groups are supporting the process somewhat, attention can be turned to business restructuring. How did we get into this fix? How can we prevent a recurrence? What changes do we have to make in order to restore profitability and sustainability, and what resources do we need to implement these changes?

If the above questions can be answered satisfactorily, then a turnaround should be achievable and the business can potentially return to more normal operations. In many cases, refinancing will be necessary, such as where there has been "lender fatigue" and a fresh start with a new lender would benefit the company. Perhaps there has been an equity infusion to bolster the capital structure. The company may have been streamlined and refocused on profitable activities. In fact, it may look like a poodle that has been to the barbershop, but it will have survived!

Alternatively, an exit strategy may be required, and most turnaround professionals formulate an exit strategy in every case just as a contingency plan. Exit strategies might include a sale or merger of all or part of the business, technology transfer, bankruptcy reorganization, or even a structured liquidation. While some turnaround professionals are qualified to act as financial advisor in selling the company, e.g., to a strategic buyer when the time available is limited, in many cases it is preferable to engage an investment banker who is experienced at marketing distressed companies. If a sale is unlikely, a structured liquidation plan could permit the maximum realization on the company's assets by completing work-in-process in an orderly way, shutting down and selling off facilities sequentially according to a plan, and maintaining the sale value of intellectual property, brand names, customer lists, etc.

Bankruptcy is a time-consuming and expensive process, and the statistics for successful reorganization of middle market companies are not promising. In the hands of an experienced turnaround professional and bankruptcy counsel, and with adequate planning, bankruptcy can be an effective sword rather than just a temporary shield. In any case where a company's survival is in jeopardy, bankruptcy analysis should be performed by a turnaround professional to determine whether bankruptcy might be an appropriate tool, and contingency planning should be done, such as engagement and briefing of bankruptcy counsel.

Back in the 1970s when turnaround professionals first came onto the scene they were sometimes called "work-out" firms, named after the workout departments of banks that handled the troubled borrowers and required these

borrowers to "get help, or else". While lenders are still a referral source, turnaround managers are increasingly introduced to their clients through equity and venture firms, attorneys and key suppliers. The failed roll-ups and LBOs of the 1990s have become typical candidates for restructuring, recapitalization and reorganization.

Some turnaround clients understandably but wrongly suppose that, since the turn-around professional may be introduced by a lender or investor, his allegiance lies other than with his client. This is where the Code of Ethics to which Certified Turnaround Professionals subscribe can provide reassurance, since it requires professionals to exercise independent judgment and avoid conflicts of interest.

Many managers wrongly suppose that turnaround professionals' only approach is to cut costs, and especially to reduce headcount, à la Al "Chainsaw" Dunlap. While a "zero base budgeting" analysis of a business can result in the elimination of unprofitable or unnecessary activities, it is actually often necessary to increase headcount in order to effectuate a turnaround, such as when the sales effort needs strengthening.

How do you know when to call a turnaround professional? What are the danger signs? Here is a partial list. Remember, these are the same signals that your lenders are watching for!

- Missed or late payments
- Delayed or restated financial statements
- Operating losses
- Need for covenant waivers
- "Stretched" accounts payable
- Slippage in accounts receivable average DSO
- Increases in accounts receivable "dilution" credits, returns and adjustments
- Need to revise plans and projections, especially if this occurs more than once
- "Hockey stick" forecasts by sales department
- Erosion of order backlog/contract balance
- Excessive management turnover
- Glitches in computer system installations/conversions

Finally, where do you find a good turnaround professional and how do you select the right one? A good place to start is the Association of Certified Management Professionals (www.actp.org). Speak to a few firms and ask them for references. Ask for recommendations from your law firm.

All too often, senior managers are "in denial", unwilling to acknowledge problems, or even if they do, unwilling to ask for or accept outside help. Like the serious medical conditions with which business problems are often compared, a key to recovery is to get help early. The turnaround professional's chances for a successful turnaround go up dramatically if he is called in before the lenders, creditors or investors require management to do so. When turnaround professionals are finally called in only when the company is running out of cash, the tools at his disposal are far more limited.

The interplay between the leasing company's position as

TURNAROUND STAGE					
	MANAGEMENT CHANGE	SITUATION ANALYSIS	EMERGENCY ACTION	BUSINESS RESTRUCTURING	RETURN TO NORMAL
OBJECTIVE	1. Select top management team 2. Weed out impediments	1. Can it survive? 2. Identify strategy 3. Develop preliminary action plan	1. Survival 2. Positive cash flow 3. Raise cash for strategy 4. Protect future resources	1. Enhance profitability through operation 2. Restructure business for increased profitability and return on assets	1. Institutionalize emphasis on profitability 2. Seek profitable growth 3. Build competitive strengths
COMMENTS	1. Select turnaround manager 2. Replace some or all of top management	1. Determine nature of turnaround 2. Three success requirements	1. Taking charge 2. Getting control of cash		
FINANCIAL	N/A	1. Cash flow 2. Breakeven 3. Profitability 4. Balance Sheet	1. Debt restructuring 2. Working capital improvements 3. Cost reductions 4. Profitability analysis 5. Sale of nonproductive assets 6. Eliminate "creative" accounting	1. Liquidity improvement 2. Balance sheet improvement 3. Control system development 4. Managerial accounting systems	1. Strategic accounting and control systems 2. Restructure long term financing 3. Develop formal stock valuation and buy-back system
MARKETING	N/A	1. Product/service analysis 2. Distribution analysis 3. Sales and marketing strategies and systems	1. Correct under pricing 2. Product line pruning 3. Weak customer/distributors 4. Sales & Marketing in line with averages	1. Product line & competitive pricing 2. Existing & new products 3. Customer & distributor. mix 4. Improve sales& marketing effectiveness	1. Explore new markets and segments 2. Find industry restructuring opportunities 3. Value added chain restructuring 4. Synergistic diversification
MANUFACTURING/ OPERATIONS	N/A	1. Facilities & equipment 2. Systems & procedures 3. Supplier analysis	1. Shut down operations 2. Reduce work force 3. Reduce inventory 4. Control purchases 5. Increase productivity	1. Productivity improvement programs 2. Periodic overhead analysis 3. Profit improvement programs	1. Restructure for competitive advantage 2. Consider strategic alliances
ENGINEERING/ RESEARCH & DEVELOPMENT	N/A	1. New products 2. Product improvement 3. Process improvement 4. Productivity improvement	1. Accelerate high potential 2. Eliminate tangential activities	1. Customer oriented new products 2. Economic value added analysis	1. Establish tech monitoring 2. Seek strategic leverage on engineering and R&D
ORGANIZATION/ PEOPLE	N/A	1. Organizational structure 2. MIS 3. Accounting & control 4. Performance & compensation		1. Improve people mix 2. Restructure for competitive effectiveness 3. Compensation to reinforce turnaround 4. Think profits & ROI	1. Institutionalize training & management development 2. Restructure occasionally to reflect changes in strategy & environment
PERSONNEL	N/A	1. Middle & first line 2. Operating personnel 3. Recruitment, selection, training	1. Change status quo 2. Reward those who change 3. Sanction those who don't		
OTHER		1. Assess strategic position 2. Viability assessment			

creditor and the customer's secured lender can be critical to a successful turnaround. The best turnaround managers bring the leasing company and the lender to the table early in order to help get everyone on the same page and avoid precipitous actions later by uninformed parties. In a recent typical turnaround situation involving a leading aircraft parts manufacturer, the credit officers from GE Capital and First Union knew each other well, and understood more about the turnaround process than their customer! With the assistance of the turn-around professional, the customer's obligations were successfully restructured to match the customer's order backlog and expected cash flow.

The leasing executive's disciplined and objective viewpoint can be critical to the turnaround process right from the outset.

Also, and this should come as no surprise to leasing executives, lease financing can be a tremendous tool for turnaround managers, since it provides a great financing alternative when cash is limited. Of course, providing lease financing to the segment of businesses in turnaround mode presents a credit challenge as well. But with the right underwriting, documentation, payment and residual structure, and pricing, the management of risk is quite achievable. *m*

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