



Turnaround Corner

The Care and Feeding of Turnaround Managers

By Howard Brod Brownstein, CTP

Although different from one another, asset-based lenders and turnaround managers are inhabitants of the same “turnaround community” and their understanding of each others respective domains often results in mutual success.

Were there ever two professions so inextricably linked, and yet so different from each other, than asset-based lenders and turnaround managers? On the one hand, we have the image of the successful asset-based lender: an integral part of an effective organization, dedicated to credit discipline, policy-driven, and somewhat conservative by nature. Focused on the ever-changing value of his collateral. His watchword is, “Yes, I know, but how does this affect the formula?” On the other hand, we have the turnaround professional: a John Wayne figure, fearless if not downright brash, unflappable. His watchword is, “How does that affect our short-term cash flow?” And yet, their understanding of each other often spells success for both the asset-based lender and the turnaround manager.

Who and what are turnaround managers? The Turnaround Management Association (www.turnaround.org), the nation’s premier organization for the turnaround community, boasts over 5,000 members, approximately one-third of whom are turnaround management professionals. The turnaround manager is a special kind of management consultant, not the kind that generates ponderous studies that wind up on bookshelves, but the kind that formulates and implements change, usually on an extremely fast track. Turnaround managers serve as advisors or interim managers for companies “in transition” — which usually means they’re in some sort of distress.

Historically, turnaround managers were known as “workout specialists”, in the days when most engagements emanated from the loan workout department of banks. The workout specialist’s main job was to get the bank repaid. However, for many years the focus has been not only on the rights of the secured lender, but of all stakeholders, and on restoring viability and profitability, and not just on recovering debt; hence, turnaround managers. And the source of referrals for turnaround assignments is as often from attorneys and fund managers, as from lenders.

Turnaround firms range from large national firms such as J. Alix and FTI, to mid-market firms such as this author’s firm, to small firms and solo practitioners. Smaller firms tend to work within their own geographic region and limit themselves

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to non-publicly traded businesses within a lower size range, while the mid-market and large firms have a national practice and may be capable of running major businesses.

How does one select a turnaround manager? One place to find leading turnaround firms is among the “Top Twelve Turnaround Firms” published annually in Beard Groups Turnarounds & Workouts (www.beardgroup.com). An indication of the professionalism of a turnaround manager is whether he or she is a Certified Turnaround Manager, or “CTP”. The certification program was launched several years ago by the Turnaround Management Association and is administered by the Association of Certified Turnaround Professionals (www.actp.org) which boasts over 200 members. CTPs must have at least five years professional turnaround management experience, pass a rigorous examination in finance, management, accounting and law, adhere to a Code of Ethics, and meet other criteria.

Asset-based lenders typically recommend to troubled borrowers the names of three or more turnaround managers with whom the lender has worked previously. The purpose of recommending more than one is to avoid both any suggestion that the lender is controlling the borrower’s business, since that might lead to lender liability or equitable subordination of the lender’s rights. However, the “recommendation” to engage a turnaround manager is usually a requirement in order for the lender to continue funding the borrower or for the lender to forbear from exercising its rights. It is therefore preferable for the turnaround manager to be engaged by the borrower, not by the lender,

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even though it may be the lender’s funds that are in effect paying the turnaround manager’s fees. It’s important to remember that the turnaround professional is not an advocate, and so the observations and recommendations made by the turnaround manager should be the same regardless of who is the client. But when the turnaround manager is engaged by the borrower, its most important job is getting the borrower to make the changes that are necessary. Any number of smart people can figure out what the borrower should do — it’s the

successful turnaround manager that can get the borrower to do it. That turnaround manager should be on the lender’s speed-dialer.

In some cases it is the lender that engages the turnaround manager, who must in such cases stop short of telling the borrower directly what it

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must do, and instead pass along observations through the lender or counsel. Where there are multiple lenders, a turnaround manager engaged by the lender group can be helpful in harmonizing differing views among the lenders and helping achieve consensus on a single course of action.

What do turnaround managers do? Their purpose is usually to evaluate the situation, determine whether the business has the financial and organizational resources to sustain viability, formulate one or more turnaround strategies, and assist in implementation of the strategy chosen — all within an extremely short timeframe. The situation has been known to arise where the turnaround manager gets a call on a Monday to be at a borrower on Wednesday, only to learn that Friday’s payroll is in jeopardy. Small wonder that turnaround managers have been likened to battle-

field surgeons: no lab tests, no anesthesia!

How much do turnaround managers cost? Most turnaround managers provide their services based on an hourly, per diem or weekly basis. The best turnaround managers will include a clear Scope of Work in their engagement agreement, along with a fee budget or range and a clear statement of the assumptions on which the fees are based. The turnaround manager’s caseteam staffing should be described along with the qualifications of staff members. Most important, the

turnaround manager’s role should be clearly delineated: are they an advisor or a manager? Where they are acting as manager, their authority should be clearly set forth, including authorization by the borrower’s Board of Directors if they are an officer. Invoicing should be monthly if not

weekly, with the activities of the turnaround manager clearly detailed. In some instances, success fees are appropriate, such as where improvement in the company’s performance can be objectively measured through share price, EBITDA as reported by outside accountants, or the achievement of an event such as a refinancing, sale of part or all of the business, or confirmation of a Plan of Reorganization.

Turnaround managers must be knowledgeable and comfortable both in and out of bankruptcy, as reorganization proceedings nearly always are a backdrop for decision-making when a company is in distress. It is the turnaround manager’s job to portray accurately how the borrower — and the bank and creditors — would fare in bankruptcy, so that all parties can achieve a common understanding of the facts. The survival statistics in bankruptcy for middle-market companies are not heartening, but improve markedly with planning and consensus building before the filing. And staying out of bankruptcy is nearly always preferable, but requires an “honest broker” to build credibility in a common plan. That’s the task of the turnaround manager.

During the current economic downturn, few asset-based lenders have much appetite for a long turnaround strategy. More and more, lenders are selling off distressed loans either individually or in a package, or else insisting on an expedited sale of the borrower’s business. The attitude of many lenders these days seems to be, “Let’s get it over with”. No doubt, bank regulators which oversee all bank-related asset-based lending groups have had a strong role in shortening the patience of credit officers. The best turnaround managers recognize this early in the engagement, and don’t waste time trying to sell the lender on a long-term fix, unless

the lender's risk can be reduced substantially and quickly, such as through a recapitalization. And since there is sometimes insufficient time to engage an investment banker in order to pursue a sale of the business, the turnaround manager may have to implement an exit strategy, rather than a turnaround, via a sale to a strategic buyer, or even a structured wind-down and liquidation. In many cases, turnaround managers have to pursue parallel tracks — looking for a turnaround strategy and beginning to implement it, while also readying a business for sale. If the borrower is in the “zone of insolvency”, it is the turnaround manager's role, in coordination with borrower's legal counsel, to

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draw this to the borrower's attention, with the concomitant shift of the borrower's fiduciary duties to its creditors.

Because a turnaround manager is not an advocate, but instead is an objective and independent agent for change in a distressed business, he or she is frequently relied upon to be the communication interface with the lenders and creditors. Asset-based lenders understandably often want direct access to the turnaround manager, without the participation of the borrower, but if the borrower is the client then such “ex parte” communication should not take place unless it is authorized in the turnaround manager's engagement agreement. This is for the lender's own protection, since without such authorization, improper communication might expose the lender to liability. Frankly, the turnaround manager should be willing to be candid and open with the lender in front of the borrower even about the capabilities of the borrower's own management team to implement the turnaround strategy.

Turnaround managers come from a variety of backgrounds: operations, finance, accounting, law and even lending. Industry specialization is seldom important, since industry knowledge is usually not what the distressed business lacks. Rather, the common problem among turnaround client businesses is poor management, and the location of most distressed business clients is in “Denial”.

A Japanese proverb says, “As the water level in the pond drops, the rocks appear.” And so it's

that as the economic downturn has continued and deepened, turnaround managers are increasingly faced with the “F” word — fraud. It appears in many forms: the obsolete inventory that is intentionally overlooked, the invoicing that is “accelerated”, the sales adjustments that aren't posted, the checks that are written and parked in a drawer while accounts payable are understated. The legal definition of fraud requires a difficult showing of intent, but as a practical matter in business, let's face it: the borrower either knew or chose not to know. Either way, the result is the same, and the lender's collateral is impaired. And the turnaround manager must insist that the borrower immediately disclose

the wrongdoing to the lender, or else the turnaround manager must resign. Note, the confidentiality provisions in the turnaround manager's engagement agreement may prevent the turnaround manager from blowing the whistle on the borrower, in the absence of a subpoena, but the turnaround manager's resignation should be message enough for the lender. So if you find out that your borrower's turnaround manager has resigned, demand that the borrower disclose why — and preferably authorize the turnaround manager to disclose to you yourselves.

Recent cases in which the author's firm has been involved portray the current state of affairs in the asset-based lending market. In one situation, a 100+ store giftware retailer was entering the slow period of late spring-early summer, when it would typically be building inventory for the back-to-school season, followed by Halloween, Thanksgiving and the winter holidays. The lender was faced with whether to allow the borrower to “reload” the seasonal overadvance in the face of covenant defaults and lackluster performance. Whereas in prior years this lender might have just tightened up a bit, perhaps asked for some modest credit enhancements, but nonetheless taken the borrower through another season, in this instance the lender had made the “mental cut” and was clearly ready to liquidate unless the equity sponsor stepped up to bat with more capital, a deal brokered by the turnaround manager. In another case, the lender group insisted on the

development of a parallel plan to sell the business alongside the pursuit of a turnaround, and when the company's performance slipped, it proceeded immediately to an expedited sale of the business to a strategic buyer, which effort was led by the turnaround manager. The sale was hugely successful, repaying the lender and creditors 100% and returning more to the shareholders than they had been offered a year earlier.

Finally, turnaround managers are an important source of business for asset-based lenders, whose lending criteria can include businesses that have incurred losses but can demonstrate an upturn and a turnaround strategy that is in process. Turnaround managers that are knowledgeable about the lender's criteria through working with their distressed borrowers, will likely know which businesses to refer to the lender as prospective borrowers, versus which ones don't meet the lender's standards. And the best-run asset-based lenders will remember which turnaround managers have sent them loan opportunities when recommending turnaround managers to their borrowers, of course determining first that the turnaround manager that is recommended is capable and reputable. So turnaround managers and asset-based lenders are important inhabitants of the same “turnaround community”, and depend upon each other for new business, credit quality, and ultimately, their mutual success. **abfj**



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