Lenders Can Help Distressed Borrowers Find Outside Help

••Financial advisers can help a troubled company assess its situation, develop a course of corrective action, and successfully execute a recovery plan.

BY KATIE S. GOODMAN AND JOHN O'CONNOR

WHILE THE UNITED States no longer looks set to replay the Great Depression, the economy remains fragile and recovery is likely to be slow. High levels of unemployment and consumer debt make it unlikely that we'll see the traditional consumer-led rebound.

The economic downturn has been especially devastating for middle market and small companies. In this period of uncertainty, business owners need help. Not all of their woes are due to the economy. Often, the signs of distress are apparent well before a business reaches crisis mode. Lenders frequently see the issues before the company does and are in a good position to give objective, helpful advice.

The Value-added of Outside Consultants

Bankers often introduce their distressed borrowers to consultants or interim CFOs. The

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role of these professionals is to clearly define the operating, structural, and strategic causes that led to the company's financial issues. This effort will include evaluating the components of the finance function—systems, processes, people, and procedures—and their integration into the company's operations.

Throughout this process, management comes to understand more fully that its interests are aligned closely with those of the lender. A greater appreciation develops for the internal value of the lender's financial reporting requirements and the relationship of financial covenants to company performance. The firm soon begins to see how useful timely financial reporting is to successfully managing day-to-day operations.

A key factor in the program's success is an early assessment of the financial staff's capabilities to:

- Determine their individual contributions to the program.
- Identify the need for temporary or full-time assistance.
- Enhance the efficiency of the process, which contributes to the company's learning experience during the consultant's engagement.

In a recent case, an entrepreneurial IT services firm experienced significant growth (revenues of more than $30 million) through a partnership with a Fortune 100 computer manufacturer. The partnership brought the company a national market and employees in more than 30 states. Nevertheless, the lender had several major issues with the company:

- An outdated computer system and limited financial staff.
- Inadequacies in controls, reporting and forecasting, and cash management.
- Continual overdrafts and acute short-term cash shortfalls, resulting from a ramp-up in expenses in advance of billings.
- Significant IRS payroll tax issues and constant late penalties because records were kept on the basis of state rather than by client or project.

In concert with company management, the consultant developed a program to address these issues. The key action steps taken were as follows:

- Immediately implementing a 90-day cash forecast and daily cash reconciliation. Collections had been based on billings, but expenses (especially payroll) were weekly and complicated by many "change orders."
- Launching a new accounting/operating system that measured profitability by project, improved margins, generated billings for out-of-scope work, and identified money-losing projects for termination.
- Issuing timely, complete, and accurate monthly reports.
- Outsourcing payroll.

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- Introducing a new CPA firm to perform the annual audit and improve tax planning and compliance.

The program was successful because:

- Profitability increased significantly.
- Pressure on cash payments was relieved.
- The bank continued to maintain its relationship, negotiating several renewals, bridge financings, and term loans.
- The owner discussed the sale of the company with several potential buyers.

Fortunately, the IT company acted in time to turn things around. But many other firms wait until they reach crisis mode and experience declining sales, growing inventories, increasing accounts payable, ballooning inventories, litigation costs, increasing senior debt, defaulting on covenants, and uncollectible accounts receivable. As these problems become severe, cash flows typically are insufficient to meet obligations to pay vendors and employees. Good employees leave the company, while the owners or management deal with the ever-present reality that lenders will no longer extend credit.

The length of this recession has resulted in another set of companies that need help. These companies barely survived the declining sales environment. Many sustained losses in 2007 and 2008, but have returned to a marginal level of profitability. However, a number of these companies have built up unsustainable balance sheets that are burdened with high levels of senior debt and stretched payables. These companies need to restructure their business and operations, formally or informally, in order to:

- Get debt in line with current revenues.
- Grow working capital as the recession comes to an end.

If you are a lender, any financial advisers you introduce to your clients must successfully address the legal and financial environment, define realistic alternatives for the company, and provide management with a sense of equilibrium throughout the process. The best way to look at this is through some examples.

Stone Importer and Wholesaler

A stone importer and wholesaler saw revenues fall from $40 million in 2007 to $25 million in 2008. Net income was negative $5.4 million in 2008. In addition, the balance sheet was far from pretty (Table 1).

Table 1

Stone Business's Balance Sheet

Assets		Liabilities	
A/R	$3,800,000	A/P	$11,900,000
Inventory	$8,700,000	LOC	$2,000,000
Real Estate	$3,200,000	Mortgage	$2,000,000
		Term Note	$500,000
Total	**$15,700,000**	**Total**	**$16,400,00**

After being called in by the lender to advise the company, a financial adviser worked with the company to form a plan that called for:

- Closing three of five locations.
- Liquidating inventory to "normal" levels.
- Eliminating more than 50% of employee costs.
- Implementing aggressive credit policies.
- Charging for returns.
- Charging for freight.
- Paying off a $2 million line of credit and a $500,000 machinery and equipment loan in eight months.

To fully help the client, the lender must have the ability to quickly earn the trust of the owners or management while gaining the cooperation of key stakeholders.

The plan brought the company to a marginally break-even level, but there were still costly leases outstanding on the three closed locations. The landlords refused to negotiate, so the company filed for Chapter 11 with lender support in September 2009. The Chapter 11 filing allowed the company to void the leases, and it emerged in June 2010 as a profitable and viable entity.

Manufacturer of Fluorescent Lighting

A manufacturer of fluorescent lighting generated revenues of $10.7 million and $200,000 of negative EBITDA, but the balance sheet was in better shape than other companies' with similar performance (Table 2).

Table 2

Lighting Manufacturer's Balance Sheet

Assets		Liabilities	
A/R	$1,500,000	Revolver	$2,000,000
Inventory	$2,500,000	A/P	$2,400,000
Machinery	$ –		
Total	**$4,000,000**	**Total**	**$4,400,00**

The lender called in a financial adviser to head up and liquidate the company as a final resort. The bank had received no communication from the management of the business and considered itself "done" with the loan.

After a day with management and a quick analysis of liquidation, the financial adviser determined that the secured lender was underwater. Consequently, the adviser proposed an alternate plan for management involving these steps:

- Assemble a package to sell the business as a going concern.
- Maintain the company on a skeleton basis.
- Negotiate with the landlord to remain in the building at a lower rent.

The plan was executed over a 45-day period. While maintaining the business, the owners solicited bids from several interested buyers. After negotiations, the company was sold for the amount of the secured note, including all fees and interest. This was a win for the lender and a win for the borrower, who had personally guaranteed the secured debt.

Conclusion

Helping a troubled borrower regain good health is a natural inclination for a banker. After all, the lender is likely to see trouble before the company does. Nevertheless, the lender may still be too close to the borrower and not have the consultant's arm's-length perspective to assess the company's situation, develop a course of corrective action, and successfully execute the plan.

To fully help the client, the lender must have the ability to quickly earn the trust of the owners or management while gaining the cooperation of key stakeholders. This is a more appropriate role for an outside interim CFO or financial adviser, whose experience and objectivity are essential to the program's success. ❖

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