



Keys for lenders and investors in assessing prospects for a successful turnaround

By Kenneth J. Sanginario

Reprint from Environmental Banker's Association presentation, Charlotte NC

January 2009

Turnarounds of Distressed Companies – Identifying and Assessing Hidden Risks

In today's economic environment, it is more critical than ever to realistically assess a distressed company's prospects for a successful turnaround, before a lot of time and capital are invested, so that lenders and investors can adopt the most prudent action plans. Digging deeper during due diligence to identify hidden risks may provide key insights to lenders and investors contemplating whether to continue to support a distressed company, and what will be required to succeed. Several areas are particularly worthy of extra effort to identify risks that are often overlooked. Each topic below has proven, in actual turnaround cases, to pose unanticipated and costly problems later in the turnaround process, when not properly assessed at the outset, sometimes resulting in major changes in strategy that could have been avoided.

Assessing Reputational Damage –

Standard due diligence would include an evaluation of the overall market for the

company's products or services ... whether or not it is growing, what the competitive environment looks like, how current economic and demographic factors might impact demand, etc. Often overlooked, however, and difficult to assess, is to what extent the Company's distress has permanently damaged its reputation and market share.

Companies are usually in denial about the extent of reputational damage that has been caused by distress, but such damage almost always exists to some extent. Market share and reputation are extremely difficult to regain, once lost, so it is wise to spend a disproportionate effort analyzing the Company's prospects for future sales. There may be warning signs in the sales backlog details that, if properly identified, could signal permanent impairment to the Company's reputation. Bookings and sales trends should be scrutinized by comparative time periods, by customer, by product, by region, by market segment, etc., and professional skepticism should be the lens through which the company's explanations

and perceptions are viewed. Additionally, extra discussions with customers should be conducted, and conducted in person, rather than by phone, as is often the case. It may be more costly up front, but the chances of gaining valuable insights are substantially higher in face-to-face conversations with customers.

If the assessment is made that material reputational damage has occurred then, at a minimum, an estimate can be developed as to the additional capital and time that will be required to repair the damage. If the damage is severe, lenders and investors might determine that a successful turnaround is unlikely, and appropriate decisions can be made before spending more time or capital fixing other problems that, in the long run, will not save the company.

Assessing Middle Management –

The typical due diligence process focuses mostly on evaluating the CEO, followed by a less in-depth review of the senior management team, and little to no review of middle management. The CEO often asserts that, despite weaknesses in middle management, and even in senior management, his leadership will elevate everybody's performance. In actuality, even a strong leader generally cannot carry a team of weak senior and middle managers to success in distressed companies. Companies which lack depth of talent in their management teams are unlikely to return to profitability. Therefore, extra effort should be made to assess whether the company has the horsepower to execute a successful turnaround and, if it doesn't, whether the requisite talent can be readily assembled.

Thorough personnel evaluations should include reviews of education, experience, technical skills, professionalism, and ... a personal pet peeve ... communication skills – written and verbal – both internally and

externally. Assigning special projects to managers early in the assessment process is a good way to test their skill sets and to gain insights regarding strengths and weaknesses. Can they put together an internal presentation that is succinct and on target? Can they develop a budget or forecast for their division or department? Can they write an effective internal memo to other employees? Can they write a professional letter or email to a supplier or customer? It is amazing how a poorly written email by a middle manager to a customer can jeopardize a multi-million dollar contract and relationship.

If management is deemed to be weak, then any turnaround plan should include formal management training at a minimum, and/or recruiting to replace the weakest managers. Either way, the additional time and cost of strengthening middle management can be factored into the initial estimates of the turnaround process, and become part of the overall assessment as to whether a successful turnaround is feasible.

Assessing Labor Market – The Company's local labor market is often given only a passing review. However, in distressed companies, employees throughout the company are often looking for new employment, which could leave the company without key resources to operate effectively. If the local labor market is not robust for both skilled and professional labor, the company's ability to execute or maintain a successful turnaround could be seriously hampered.

Positions within the company should be ranked by level of importance, and the local and regional markets for key positions should be thoroughly analyzed, including the competition for similar talent by other companies. Can the region even support the company's need for key skilled or

professional labor? What is happening to regional wage rates for the types of key people the company might need? Without the ability to readily recruit talented new employees for any position within the This issue may be particularly true in areas of the U.S. where there are not high concentrations of colleges, since many graduating students settle in the same markets where they attended school.

If the labor market analysis is not favorable, then the feasibility of other options may need to be considered as part of the initial strategy. Possible solutions may include moving the company's headquarters or establishing satellite locations in better labor markets, each of which could be time consuming, costly, and difficult to execute successfully. However, at least the estimated impact of any issues can be factored into the overall assessment before going too far down the turnaround path to easily change course.

Assessing Supplier Base – If suppliers have been asked, and have accepted, termed payment arrangements, or deep discounts, in satisfaction of old payables, and are continuing to ship product, the conclusion is often that the supplier base is intact. A deeper analysis, however, may reveal that supplier service, response times, quality, price, delivery, etc., may be deteriorating to such an extent that the company's market share and/or margins will continue to erode for the foreseeable future.

Extra effort should be made to analyze trends of supplier prices, delivery times, service, and quality issues before and after the company's distress began. The results could provide key indications of what the company might expect for the near future. Will the company be able to remain competitive in terms of delivery times without stocking an unreasonable amount of

company, and at affordable rates, it could be very difficult to change corporate culture, improve overall employee performance, or merely replace people who leave.

additional inventory? Will its margins suffer because suppliers are being price punitive? Will the company lose business because its suppliers will not accommodate rush or other special orders? Will suppliers inform the company of new and improved products or materials at the same time they inform competitors?

Certainly, the above issues can be somewhat mitigated if alternative suppliers are available. However, if an alternative is not readily available for even one key supplier, the impact on the company's turnaround efforts could be material. At a minimum, it may be that additional capital will be required to accelerate settlement payments to the trade, or to stock more inventory, in order to protect customer delivery schedules. However, there could also be long-term impacts on margins or competitiveness, if the company's suppliers decide to try to recoup past losses through future price increases. A careful assessment at the outset could significantly impact the company's projections and, by extension, the determination of initial strategy.

Assessing Corporate Culture - Often not part of the due diligence process at all, few areas can have a more dramatic impact on a company's ability to return to good health than its corporate culture. It can't be measured quantitatively, but one can certainly get a qualitative read within a relatively short period after beginning the turnaround process.

In many ways, corporate culture is enmeshed with senior and middle management evaluations, but the culture goes beyond talents and skill sets, and is so

important that it warrants its own evaluation. How people respond psychologically to new processes, new challenges, new responsibilities, and new expectations, will play a huge role in determining whether the turnaround efforts will ultimately succeed. The culture must come from the top, but be carried throughout the company by the senior and middle management teams. Are they are willing to do whatever it takes to succeed? Are they willing to accept tasks or projects outside of their standard job responsibilities? Are they willing to work overtime – nights and weekends, if necessary – on a regular basis during the turnaround phase? Are they capable and willing to project a positive attitude to their colleagues, subordinates, customers, and suppliers? If yes to all, the Company's chances of success are much greater. If, on the other hand, they are not up to the challenge of a prolonged turnaround effort, no amount of talent or skills will matter.

Assessing the corporate culture as early as possible can have a significant impact on the strategy adopted by a lender or investor. In this case, it may not be an issue that additional capital can fix but, rather, an issue that points to the company just not being able to sustain a grueling turnaround effort.

Assessing Other Quality Factors – Companies in distress often have not invested in various other key operational areas, any of which could make a turnaround effort more difficult and costly. Examples include Quality Control Programs, ERP and Cost Systems, Safety and Environmental Programs, and Management and Employee Training. If these areas have been historically ignored, or are marginal at best, there is significant risk that additional unexpected and costly problems could surface before the turnaround effort is completed. Additional time and capital

should be estimated up front to address these areas as part of the turnaround process.

Summary - Turnarounds are more difficult and riskier than ever in the current economic environment. While every effort should be made to help companies recover from distress, to return to profitability, and to preserve jobs, lenders and investors must also heighten the due diligence process to identify and address hidden risks as early in the renewal process as possible. By doing so, the cost and time estimates of executing a successful turnaround might be much higher than otherwise, but the better information will allow for more prudent strategies to be adopted at the outset, rather than changing courses midstream or absorbing significant unexpected additional costs along the way.

Ken Sanginario is presently a Founder and Principal in the Boston firm of Northstar Management Partners, LLC and formerly a Principal with Transitional Strategies. He has 25 years of financial and operational experience, the last 15 of which have been spent helping distressed companies return to profitability.