Turnaround Management

GROWTH AND INCIPIENT DECLINE IN SYNTHESIS

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Using an actual case, this article examines a paradigm that appears fraught with dichotomy and contradiction. This is the existence of robust growth and incipient decline in the same organization. Shocking as it may seem, business history is replete with such cases. The article seeks to provide the stakeholders of such a case with insight concerning causes of decline and their early detection.

Turnaround practioners often see corporate denial as a creature of infinite resource. Often such denial is imbued and embedded very strongly in management, the Board and even lenders.

Decline can be inexorable, unless an aggressive attempt is made to reverse it. Without a resolute effort, decline becomes a continuum with distress and liquidation perched on the end points. And at some point, shareholders and other stakeholders find themselves aghast in the midst of a full- blown crisis, wondering how such a catastrophe happened.

Such a situation is especially shocking to all when disaster occurs within the context of rapid and robust growth. At first blush, this appears to be a contradiction or dichotomy. Yet corporate history is replete with such cases. This includes larger companies that had both financial and management resources, supervised by boards, and with sophisticated secured lenders providing capital.

I recently completed an assignment that represents a perfect paradigm of meretricious glitter that soon became tarnished. The glitter was so seductive that lenders continued to advance funds even though reasonable cash projections indicated insolvency in a few months. Most stunning is the fact that they never believed they were funding distress, but rather a growing and vibrant company, nor had they been deceived by fraud or misrepresentation.

This story begins with a small company founded over two decades ago. Viewed as allegory, this tale has value to a variety of stakeholders. From this story readers will:

- Develop a grasp of the basic causes of decline.
- Gain insight into the early detection of distress
- Be able to construct a corporate platform that resists distress and warns of its insidious approach.

The tale begins about three decades ago with a hardworking immigrant seeking increased opportunity by founding a company which repaired specialized equipment used in material handling. As is often the case, initiative, dedication and drive resulted in some success.

The founder then decided to actually manufacture the same type of equipment that he had been repairing and had some success with the first units that he produced. By this time, his son and daughter had become involved in the business. The goal was to increase sales from about $5 million to over $30 million in about four years. All principals were responsible and dedicated; however, none had experience outside of the business. Nor did anyone have experience in the execution of a high-growth strategy.

At the time of my engagement, sales were about $10 million per year. Products were sold primarily in North America and Europe through direct sales and distributors. An aggressive expansion was well under way with the completion of a sparkling new manufacturing facility with all of the trimmings. This was accomplished through the use of leverage and the company had borrowed just over $9 million in a combination of term and operating facilities. In fact, the company was gulping capital; they had borrowed about $2 million in total over the last two years. The last tranche was advanced during my engagement and there were 3 or 4 lenders who had tabled term sheets. Their enthusiasm validated the high-leverage, high-growth strategy chosen by management. Advances over the last two years or so represented approximately a one-to-one ratio in debt to sales growth, i.e.; every dollar in sales required a dollar in debt.

Sales growth had clearly outstripped infrastructure, particularly MIS and accounting. Some salient issues: although adequate hardware and software was present, internal profit and loss statements were not produced, the use of working capital in growth was not understood, ERP software had been purchased, but not implemented, and gross margin by product or client was not known.

The sales target of $30 million in sales within a few years was not supported even by a rudimentary strategic plan. In general terms, lenders were aware of this situation.

Given the paucity of internally prepared plans or financial information, the primary tools for management were external accountant-prepared financial statements on an interim and year-end basis, and on cash projections. Financial statements were not audited and some contained a full disclaimer. The accountant in question was a sole proprietor who was certified. Unfortunately, this information was the primary source of guidance for management and lenders. Conveniently, it was also sufficiently obscure for the tax department.

Even considering these limitations, the information had some utility. Some components such as payroll, building costs, AR and AP could be easily verified, facilitating the preparation of more useful financial statements. Also information can reveal through what is not said or addressed -- much as a guard dog who does not bark in the night. At the time of my engagement the following information was available:

- Income Statement and Balance sheet for the Year ended April 30, 2010
- Income Statement and Balance Sheet for the Year ended April 30, 2011
- Interim Income Statement and Balance Sheet for the period ended Sept. 30, 2011
- Projections including Income Statement Balance Sheet and Cash from May 1, 2011 to April 30, 2012
- Accounts Payable/Accounts Receivable/ Inventory as at Sept. 30, 2011

This information was prepared externally(by outside firm). Prior information was not readily available. This was due to the fact that prior-to-2010 operations were not recorded using a single entity. Multiple small companies served different functions such as equipment rental, repairs etc. The purpose of this was to take advantage of tax breaks for companies with profits under $150,000. Administratively, this proved burdensome and a consolidation was done.

Financial Notes
This information appears fairly positive. This company was growing and was able to service its debt. Liquidity was good and the company appeared to operate from a decent capital base. The shiny new facility received attention and lenders were vying for the opportunity to provide more capital. In fact, the company received a new loan of $1 million after preparation of the September 30 interim statements. Not only did the shareholders feel validated by all of the attention from lenders, they believed that management practices were nearly perfect. I note the following:

- The cash projections for the period from May 1, 2011 to April, 2012 are not reproduced due to space limitations. They estimated sales to be nearly $10 million and also predicted that the company would generate an abundance of cash. The reality was quite different and during this time a liquidity event nearly occurred. It was avoided by a fast increase to operating loan. My own calculations for a period from October 2011 to October 2012 indicated that in the best case the company would experience a cash pinch. In the worst case it would become insolvent with an accrued deficit of over $1 million by mid-year. This is after the new $1 million loan.
- It was also likely that the company had lost money in the last few years. Deferred development costs are salient. They reflect credits for Research and Development expenditures. Subject to federal government approval, the company receives an actual check for half of R&D expenditure. This claim had been outstanding for some time and the shareholders had doubts about recovery. The new

A Financial Summary:

	4/30/10	4/30/11	5/01-08/30/11
Income Statement			
Sales	6700	7800	3000
COG	5500	6300	2300
GP	1200	1500	700
SGA	900	1100	500
Income pre tax	300	400	200
Net income	250	390	190
EBIDTA	990	800	290
Balance Sheet			
Cash		135	5
A/R	2100	2200	2100
Inventory	3400	3200	3900
Total Current Assets	*5500*	*5535*	*6005*
Capital assets	320	460	530
To related companies	900	1625	1700
Deferred Development	880	880	880
Total Assets	***7600***	***8500***	***9115***
Liabilities			
AP	500	730	890
Tax	40	40	
Bank	4200	4000	4300
Current Term Loan	30	100	100
Lease	30	30	10
Current Liabilities	*4800*	*4900*	*5300*
From Shareholder	1100	1500	1600
Cap Stock	100	100	215
Retained Earnings	1600	2000	2000
Total Liab&Equity	***7600***	***8500***	***9115***

lender did not require any information to enable them to determine the probability of recovery. If these funds are not recovered, then it would result in a charge against income of $880,000, wiping out profit for almost the last three years.

- Advances to related companies of just over $1 million is due from the small companies that were previously used by the shareholders. These companies are defunct and have no assets; therefore, the $1 million cannot be recovered.
- September 30, 2011 A/R and A/P and prior to the $1 million injection indicate that over 50% of A/R were over 120 days. A/P were $800,000, of which $500,000 was over 120 days. This is especially notable, given that the company had just borrowed $1 million in the year prior to the last $1 million advance. This is usually a sign of distress.
- Working capital components were not well managed. A/R were not subject to a consistent credit or collection policy, nor were deposits required from purchasers. Inventory with a recorded value of $3.8 million was comprised of parts, WIP and finished goods. WIP and finished goods did not even represent 20% of this amount. Relative to sales inventory was bloated and had not been actually counted for years.
- Lastly, I reference $9 million in debt and the reader will note that only $4.8 million in current liabilities are shown. The $4.8 million represents operating loans. For analytical purposes, I also include a mortgage on the building which is held in the name of a shareholder. It is serviced through rent paid to the company.

The glitter of this company was more than merely tarnished. In fact, what was thought to be a vibrant enterprise was nearly insolvent. In this condition, a lender had just advanced $1 million. Other lenders including a government body had loaned another $1 million the previous year.

Clearly, our subject was replete with the causes of decline, including:

1. A lack of rigor surrounding cash management
2. Poor to nonexistent controls for manufacturing, planning and procurement
3. A disconnect between financial measurements and key performance drivers
4. A lack of accountability within management ranks

Empirically, the warning signs of distress were nearly incandescent. Observing them was impaired by myopia, not malfeasance or fraud. First and foremost, the company was consuming working capital prodigiously and had terrible aging on accounts payable. How could the company receive repeated infusions of capital over two years and yet over 50% of A/P still remained over 120 days? This is a classic red flag to any experienced lender. In most cases, when a company is constantly seeking new funds, it is losing money.

Similarly, existing cash projections bore no relation to reality which was incipient insolvency. With respect to profitability, the balance of probability was clearly skewed; it was likely that the company had lost money on operations for the last few years. It had been depending upon a government subsidy that was not likely forthcoming. The status of this situation was obscured in year-end financial statements and unconfirmed by lenders.

Clearly management was not accountable except to themselves as a family, but not to the organization. Cash management did not exist; it was not even understood. Performance could not be understood because critical data was not measured. The most notable example of this concerns gross margin. The GM for each piece of equipment produced was not known and costs were not monitored during production. Thus, manufacturing lacked control, planning could not exist, and procurement discipline was unfettered, as evidenced by inventory levels.

This company was a clear candidate for a turnaround. Such an effort may be thought of as a transformation that has been tragically delayed. This need for metamorphosis is driven by a lack of corporate resilience which permits an organization to change and adapt as necessary. It is such resilience that provides resistance to decay and a platform for recovery. It is founded in critical thinking and requires that organizations overcome cognitive challenges of eliminating denial, nostalgia and arrogance.

At its core, corporate resilience requires a culture of performance management. Such a culture exists when employees use practical management tools to set targets, measure performance and implement concrete action plans to meet objectives. Organizations that have established a culture of performance management exhibit three core elements: leadership, capability and accountability. This troika provides the drive to use human resources to meet objectives and a review process for measurement and tactical changes. Lastly, they tie action to responsibility in a transparent environment. Transparency is essential -- the devil cannot live in sunshine.

These core elements in synthesis with key principles permit the implementation of performance management. The key principles are: to identify core drivers, establish targets and review progress.

A culture of performance management and the tempered steel of the resilient organization lay at the nexus of these core values and principles.

In such an environment, the incipient cancer of decline would have been recognized and addressed, even nestled amidst the glitter of rapid growth. **TSL**

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