A Lawyer's Guide to Turnarounds and Workouts

By

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Introduction

(Note to Reader: This guide was written a couple of years ago, primarily to help business owners and managers. Now more than ever, those managers are looking to their legal and business advisors for help in challenging situations. I think that many of the ideas herein are relevant to lawyers as they help their clients.)

You are the advisor to or owner or key manager of a manufacturing (or distribution, retail or service) business with approximately $10 million (or $1 million to $1 billion) in sales. Your business last year had a small loss but this year the loss is greater. Aside from the financial issues you are facing with the business, you have some other issues and factors to address:

- Your bank is complaining that you often miss your projections, especially in the past year. Your banker is also suggesting that, even after years as your lender and gaining thousands of dollars in fees from your business, he thinks you should find another lender.
- Your largest customers are reducing their orders and (annoyingly) are saying they have too much inventory of your product (well, you say that is because they are not doing a good job marketing and selling it).
- Your largest vendors are complaining that you are paying too slowly and want to reduce your credit line.
- Finally, your Chief Financial Officer (or Controller or Executive Vice President or VP of Sales) is saying to you that he is underpaid and can be doing better elsewhere. He is also asking you to follow-up on that statement you made last year about wanting him to become a shareholder.
- Oh, and one other main issue is in front of you. Your Board (of Directors or of Advisors) is criticizing you for not having implemented your last strategic plan well, even though many of the assumptions in it have now changed. You know that plan, which showed projected good returns on investment to your shareholders, is really out the window. As a result of what has happened recently, the value of your business is much less than it was 12 months ago.

(If you are the owner or family member of a family-owned business, you have additional built-in challenges to overcome. One of them is the organizational structure endemic to a family business).

Why You Need to Read This Brief

This situation described above is common to many businesses, more common than many managers and owners realize. I have been in the middle of these types of issues many times in the past fifteen years. As the head of a manufacturing company and as an advisor to owners and managers since the mid 1980s, I have faced these challenges and

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want to offer you some recommendations on how to overcome them that will really help you.

You need to read this brief and will benefit from it if:

- You advise, own or manage a business or have a business unit that is performing below your expectations or those of your shareholders, employees, creditors or customers
- You want to improve your business' cash flow to be able to have more cushion to meet its obligations and to grow
- You want to sort through all the advice, much of it conflicting, about how to manage through a crisis or business challenge

How do I know what to do and why can I give you advice? My advice is based on experience and study. As I said above, I have run three businesses, one a manufacturer/distributor and two service firms. I have also advised the management of more than 100 businesses regarding improving cash flow, developing strategic plans, handling and solving crises, refinancing and recapitalizing. On the study side of the equation, I have an MBA from Carnegie-Mellon, written *The Turbocharged Company*, and numerous articles on turnarounds, workouts and marketing. One thing that has become apparent from my study is that it is very difficult to turnaround a business and the chances of success are low. However, those chances can be improved by some of the recommendations below.

This brief will serve you as a manual for turning around your business or to provide advice to others. The beginning of this brief provides an overview to you of the types of issues managers face in a turnaround and the nature of the challenge. The middle of the brief gives you some real tips on developing and implementing a turnaround plan. Finally, the last part presents recommendations on how to avoid the situations that could cause your business to become troubled. I have sprinkled turnaround tips throughout the brief, usually at the end of a section, to reiterate a key point.

Turnaround Tip: At the beginning of a turnaround, read this and have everyone on your team read it also, including your attorney and lenders.

Definition of a Company Needing a Turnaround

This brief is about how to turnaround a company. Businesses that need turning around are troubled or underperforming. I define a troubled company as one that

- Had two consecutive quarters of losses or
- Had two consecutive quarters of below plan performance

An underperforming company is harder to identify quantitatively but some indicators I use are

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- Return on equity, return on assets or other key indicators of performance are below most of the Company's competitors
- Its owners and many employees are dissatisfied with the Company's current performance and prospects
- Turnover of the best employees is a major issue
- The Company's growth in revenues has been below that of its market, meaning its competitors are growing at faster rates

Managers in both troubled and underperforming companies will benefit from this brief.

Your Biggest Challenge

Communicate the Bad News and the Good

You know that the problems you face are not your fault. Most have been caused by a conspiracy of factors, including the economy, the industry, the problems of a large customer, or the loss of some key managers. However, unless you are leading General Electric or a similar large company, the problems you face are relatively huge and will take great skill to overcome (a fact is that the smaller your company the greater the impact of problems on it).

Your biggest challenge is that most of the people with whom you will be working to turnaround your company will not have that same perspective. Bluntly put, they will think the current problems and situation are your fault. Those people who feel that way will include most of your employees, your lenders and other creditors and other groups such as your customers, your employees' families and the media. The obvious problem that creates for you is that, since 80% of all troubled companies do not turnaround and even more fail to make it if they are under $25 million in sales, these same people will not believe much of what you say in terms of plans for the future and your turnaround. You do not have much credibility at the beginning of the process, especially when it involves improving profits and cash flow in your business (a compelling reason to enlist the help of an outside advisor who has credibility with the parties with whom you need to work).

Much of your effort during your business' turnaround will be, by necessity, targeted at overcoming this disbelief in what you are saying and proposing. You may consider this challenge to be mostly unfair and unwarranted but it is a fact of life with which you must cope. Much of the work I do with my clients is in the area of regaining credibility and belief. Below, I will discuss how to recover it.

Even though most of the problems you face were not caused by you, it is important to understand the two types of mistakes that management make. This understanding will help you communicate to outsiders the causes of problems and what will be done about them. The first type of errors made is errors of commission. These are characterized by

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the example of a poorly thought out and executed acquisition. The second type of error is of omission and is characterized by an example of not identifying and fixing the cause of losing and important customer due to late shipments. Most errors occurring in troubled businesses are due to omission.

Turnaround Tip: If you have made mistakes or know of bad news not yet known to other parties, the beginning of the turnaround is the best time to admit or inform everyone. Even in the most difficult situation, management will gain a respite and some respect from everyone.

Stay Healthy

While I am focusing at this point on your own actions and perception, I should mention the important aspect of your personal well-being. Based on my experience, your personal keys to success in leading a turnaround have to include;

- Do not panic
- Control your stress (you will have a lot of it) through exercise and diet (minimize pharmaceuticals, caffeine and alcohol)
- Get enough sleep

I have found that as managers' physical abilities decline through inattention to their personal well-being, their professional ability declines similarly.

Turnaround Tip: Remember the pressure you feel flows through to your family and friends if not managed properly.

Sort Through The Noise of Recommendations

The gurus and experts may give you a false sense of simplicity regarding the process of turning around your business. There are lots of books to read, by experienced managers (some who are vilified now such as Al "Chainsaw" Dunlap (former CEO of Sunbeam)), consultants and business writers, and a lot of other sources of advice.

Let me help you with this brief summary of the pitfalls to avoid;

- *The easiest path is usually wrong*, for example
  - Cutting costs through laying off people (without a plan in place to exit certain businesses or other similarly thoughtful reduction plans) may have short term positive impacts but usually results in diminishing the overall value of your business – the reason being that the work you spent hiring good people, the "A" players as the economy and your business were flourishing, would be wasted

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        - Keep in mind, that most recessions only last less than one year
        - The remaining employees, after layoffs, now have more work to do with less opportunity for increased compensation (because their company is doing poorly)
- *Don't leap before you look*
    - Act decisively but with a plan
    - Often the best decisions are the ones not made

Turnaround Tip: Ask you lender and/or largest creditors to hold off on pressuring you for several weeks so you can properly evaluate your situation. Be sure to get their input during that period.

The Turnaround Model and Process that You Should Use

My clients and I have found that it is very helpful in a turnaround or a challenging situation to have a framework upon which to build analysis and subsequent decision-making. Think and apply this model as you move forward with your own work and action planning.

The model or framework I use is reflective of the experience of treating a critically injured person. Think about it, whether you or a close family member or friend have been critically injured or you have happened to watch *ER* or *St. Elsewhere* on television, you probably have a real sense of the stages of treatment and recovery of an injured person. It is very similar to the process of turning around and helping to recover and renew your business.

Turnaround Tip: Keep plans and communications as simple as possible.

Phase One - Survival

An injured person goes through three phases of treatment. Each phase occurs in a different environment. Phase 1, Survival, occurs in the Emergency Room (ER). Phase 2, Recovery, takes place in the Intensive Care Unit. Finally, Phase 3, Rehabilitation, can occur in several places such as in the hospital or at home.

Let's first review what type of treatment occurs in each phase of medical treatment, and then I can easily relate it to your business. In the ER during Phase 1, a team of medical professionals works to save the patient. It is relevant to the process to discuss the concept of a team of professionals working together to achieve a goal in a crisis.

The ER team consists of a mix of emergency room physicians who specialize in rapid diagnosis and action, and similarly specialized and highly trained nurses and other assistants. As needed, on a patient-by-patient basis, specialists from elsewhere in the medical center are brought in to consult or act. The entire team has a leader and is one of several teams continually formed and then disbanded after completing a case in the ER.

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The ER team goes through a similar process with every patient. First, they determine the patient's condition. They measure heart rate, blood pressure, alertness and other vital signs. Second and usually simultaneously, they diagnose the cause(s) of the patient's condition. This diagnostic process has many elements, many of which are based on interviewing witnesses. Some of the questions asked may include whether the patient was in an accident, the nature of the accident, the time and environment in which it occurred, the patient's health prior to the accident and other sometimes obvious but important questions.

Third, and simultaneously with the other steps above, the team works to stop the further deterioration of the patient. For instance, if the patient is bleeding, the team acts to stop the bleeding. If the patient is in cardiac arrest, the team attempts to restart the heart.

Once the patient has been stabilized and the team has a diagnosis, the process of then developing the plan and approach to recovery and rehabilitation can occur. That process and the result have several important characteristics that are very relevant to the process of turning around a business.

Turnaround Tips: You and the team have to do three things at once: keep the Company breathing, diagnose what caused the trouble, and develop a plan to help the Company survive in the long term. Recognize that you need help coping with this volume of activity and also need the expertise needed to make the right decisions.

Relevancy to Your Situation

The first relevant characteristic is that a team develops both a medical recovery plan and a business recovery plan. A team, made up of people from different functions and experience levels, has the best chance to develop a plan that is practical and reasonable. The differing experiences and views of the team members really is a great aid in the plan's development. Each team also benefits from having one or two members who have "been there before", meaning they have been in similar situations previously and have succeeded.

A second relevant characteristic of a successful plan is that it clearly states the goals to be achieved by the patient or the business. Whether it is having that patient walk unaided or that business refinanced with lower debt service costs, the clarity and descriptiveness of the goals must be clear to everyone on the team and eventually everyone involved later with that patient or business.

The third characteristic is that the plan must be detailed. It is usually not that difficult at a high level to figure out what to do in a crisis or turnaround or what the problems are. The challenge is to develop a plan that is doable, believable and saleable. A plan must have the elements of depth of detail, clear timetables and distinct accountability and

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measures of success or failure along the way to be a success, for both the patient or for the business managers.

A final relevant characteristic is a bias towards action. “Paralysis by analysis”, “deer caught in the headlights” and other phrases describe many inexperienced management teams when faced by a crisis.

Turnaround Tip: The successful teams quickly determine what needs to be done and then do it.

How To Do It – Survival

So far, I have described some of the environment of a turnaround, given you recommendations as a manager on the right aspects to focus upon and the perspective of those around you. Finally, I have also provided you with a medical treatment framework upon which to develop your approach.

Now, I are at the point where I can tell you what you should be doing in some detail to actually turnaround your business. I will segment these recommendations into keys that you and your team should keep in mind.

1. **Stop the bleeding** – just as the ER team makes sure that their patient is stabilized, you and your business team must stabilize your business. Its lifeblood is cash, measured by cash flow. *Cash flow* is a combination of profit or loss and changes on the Company’s balance sheet. Increases in assets use up cash while increases in liabilities generate cash (by avoiding disbursing cash to reduce a liability). I know that your team needs a real understanding of the dynamics of cash flow because that will drive many of your decisions, plans and communications to outsiders. Also, remember that cash flow is really the driver not only of survival but also of your business’ ultimate value. Every dollar of cash flow now has at least a multiple of 5 as a major way of valuing business.
    i. For example, if your business generated $1 million of cash flow in the past 12 months (define cash flow here as Earnings before Interest, Taxes, Depreciation and Amortization) then with a multiple of 5, it is worth $5 million. The equity of the business is valued at that $5 million less interest bearing debt.
    ii. You can see that each additional $1 of cash flow is worth $5 to the owners of the business (probably including you).
    iii. Below is a schedule called *Weekly Cash Flow* that you and your team should prepare to be able to understand your business’ cash flow in the short term and to be able to control and manage it better. It is also a schedule that your bank(s) will want you to prepare and maintain. It should be on a rolling 13-week time frame and be updated weekly to compare actual cash flow to projected cash flow.

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Weekly Cash Flow Projections

		Week 1 **Mar. 19**	*Week 2* **Mar. 26**	*Week 3* **Apr. 2**
Cash In				
Sales		-	100,000	155,382
80% of Sales		-	80,000	124,306
Collections		25,000	25,000	25,000
		-		-
Total Collections % Kept	20%	5,000	5,000	5,000
Net Cash After Paydown				
Note Only; Total In		25,000	25,000	25,000
Cash Out				
Manpower				
Payroll		50,000	-	64,036
Payroll tax		10,000	-	10,000
Medical insurance		-	25,000	-
401K payback		-	7,500	-
Total manpower		60,000	32,500	74,036
Utilities				
Electric		7,000	7,000	7,000
Gas		-	-	-
Water		-	10,000	
Telephone		-	1,500	-
Total Utilities		7,000	18,500	7,000
Supplies and Maintenance		-	5,000	-
Moving Expense (electrical, other)				
Material			10,000	
Debt Service				
Lender			24,000	
Lessor		-	2,000	-
Total Debt Services		-	26,000	-
Liability Insurance		5,880	-	-
Payments to Major Creditors				
Taxes		5,000	5,000	5,000
Vendors		5,000	-	5,000
Other		-	2,000	-
Total Payments to Creditors		10,000	7,000	10,000
Rent		-	10,000	-
Transaction Fees & Legal				
Total Out		82,880	109,000	91,036
Net Change in cash prior to LOC		(82,880)	(109,000)	(91,036)
Change in revolver		(68,632)	55,000	99,306
Extraordinary Cash In				
Total change in cash-for the week		(151,512)	(54,000)	8,270

Exhibit 1

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Let me explain what you are seeing above in Exhibit 1. It is a very simple schedule, basically similar to your checkbook, showing receipts of cash and disbursements. It is linked to the schedule (*Analysis of Line of Credit Balance (Exhibit 2)*)below, which calculates how much your business can borrow, based on receivables and inventory. For this section, I will assume that part of your Company's loan facility is a revolving line of credit. The top section of Exhibit 1 shows cash coming into the business through borrowings on new sales for that week at 85% of value and through collections of receivables and other cash collections. The bottom section titled *Cash Out*, shows cash disbursed or paid in several major categories beginning with manpower.

- The difference between cash in and out is the *Net Change in Cash prior to LOC (line of credit borrowing)*.
- The next line is *Change in Revolver* which shows the amount that the Company can borrow or must pay back on the revolver based on the effect of sales, collections, debt service payments and inventory changes.
- The bottom line is the real bottom line to you and your team, the *Total Change in Cash for the Week*. In the case of this sample company, that cash flow only becomes positive in week 3.

The schedule below accompanies the *Weekly Cash Flow Projections* in that it calculates what amount may be borrowed or must be paid off on the Company's line credit. It calculates the change in revolver, which shows at the bottom of the *Weekly Cash Flow* schedule (Exhibit 1).

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	Week 1 **Mar. 19**	*Week 2* **Mar. 26**	*Week 3* **Apr. 2**
Analysis of Line of Credit Balance			
Beginning L-O-C Balance	511,482	442,850	497,850
Add Advances	-	55,000	99,306
Minus Repayments	68,632	-	-
Ending L-O-C Balance	442,850	497,850	597,156
Cash on balance sheet	-	-	-
Collateral Analysis	**Actual**		
Total A/R-Trade	301,000	376,000	506,382
Accounts not Qualified	(93,000)	(93,000)	(93,000)
Qualifying A/R:	208,000	283,000	413,382
Qualifying A/R Balances	166,400	226,400	330,706
Advance Rate 3/5/01			
Total Inventory	302,900	302,900	336,000
Less: ineligible inventory	(120,000)	(120,000)	(120,000)
Eligible inventory	182,900	182,900	216,000
Qualifying Inventory Balances	91,450	91,450	108,000
3/7/01 Forced Balance	91,450	86,450	81,450
Collateral prct. Allowed:			
A/R	166,400	226,400	330,706
Inventory	91,450	86,450	81,450
3/7/01 Overadvance	185,000	185,000	185,000
Total Qualifying Assets	442,850	497,850	597,156
Less: Amount Advanced by Fe	-	-	-
Total	442,850	497,850	597,156
Excess/ (Deficiency) in L-O-C A	-	-	-

Exhibit 2

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2. **<u>Get help</u>** – just as that patient who enters the ER with a partially severed leg does not try to operate and treat himself, managers of troubled companies should embrace a similar thought process. The turnaround will have a much higher likelihood of success if the management team has good advice from seasoned business advisers, attorneys and investment bankers.
3. **<u>Recognize that you have a problem</u>** – many managers and owners are too slow to recognize that their business has serious and threatening problems. To continue the medical analogy, the patient's oxygen supply becomes threatened if too much blood is lost. The same for a business if too much cash is lost.
    a. A key indicator of a problem in your business is when projections of income are missed in two consecutive quarters. Once your management team falls behind in meeting projections, it becomes almost impossible to catch up to get back to even. Waiting too long *does make it absolutely impossible to catch up.*
4. **<u>Be sure that everyone in your business knows that it has problems and also what its current performance is</u>** – to best illustrate this point, I will change from a medical analogy to a football one. Imagine that the Cleveland Browns are losing by 4 points to the Baltimore Ravens. The game started at 1 pm and it is now 3:50 pm. The Browns offense has the ball but a fog has rolled in from Lake Erie and no one in the stands or <u>on the field</u> can tell the down, the yardage needed for a first down or even the yard marker on the field for the location of the ball. If you are Tim Couch, the quarterback, or Butch Davis, the head coach, how do you know what play to call?
    a. I see so many management teams and companies in exactly this situation. They do not have the information to know how they are doing. They may sense they have a problem, that it is getting to be near the end of the game, but they do not know the depth of the problem (how much time is left and how far they have to travel) or the source of the problem. In business, that source or cause of the problem might be a money losing division or group of stores, a few "loss-leader" customers or a variety of other reasons. The point is that if managers do not know the reason for problems, they will not do anything directly about it to resolve them.
    b. Finally, to finish the football/business analogy here, can you imagine how Browns owner Al Lerner must feel watching this game and seeing the predicament his team is in? He likely would be yelling and screaming down to them to hurry up and do something, anything. Just think, though, would it be a good idea for Couch to do just anything, like fade back and throw the ball deep? No, of course not, he does not know the down, where he is on the field and cannot even see his receivers well. The chance of him succeeding would be very low.
    c. The solution in a business faced with a challenging situation is this:
        i. Communicate as clearly as possible with your employees, lenders and other major stakeholders the problems the business faces

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ii. Develop and implement a Daily Flash Report, which indicates 4 or 5 key business performance indicators. Make sure almost everyone in the Company sees that Report daily. Moira Lardakis, a senior manager at Progressive Corporation, says it well with the phrase "what gets measured, gets improved". When employees see that daily corporate scorecard they work to improve it, it becomes their yardage and down markers. The Daily Flash Report gives managers the basic information they need to make adjustments to their course during the month, not just after the month.
iii. Close the financial books within a few days of the end of the month to be able to see exactly how you did. Also, be sure to analyze major differences in projections compared to actual.

5. **Treat your lenders with kid gloves** – They really need to have special treatment, different than any other parties with whom you are dealing. There are two reasons for this treatment. The first is that the lenders control your lifeblood, cash. If they make up their minds to get their money back, there really is little that you can do to stop them. You should continually be telling them (and mean it) that your first goal is to make sure that they get paid back. Secondly, they are very risk averse and there will be some risk inherent in your turnaround plan. Even if the only risk is that they have to believe you a little bit.
6. **Unleash People Power** – For this turnaround to work, it requires a lot more effort and teamwork than just that which you and your management team can provide (in the Recovery Phase below, I will discuss this further). Everyone in the Company, without exception, has to support the turnaround. Those who do not support the effort have to be brought on board to the effort or they will have to leave. Unleashing people power is based upon involving people in decisions, informing them of what is happening and providing them with enough information so that they can improve and finally incentivizing them properly so that their compensation is directly tied to the goals of the Company. It is easy to conceptualize this effort but very difficult to implement and requires great skill and energy on your behalf.
7. **Develop a good plan and also have a detailed plan to implement it** – Now that you and your team(s) have a good handle on how you are doing and have stopped the bleeding of cash or at least slowed it, you need to develop a strategy for turning around the business and creating value. In the following section, I will discuss how to build the structure of the plan, its elements, and its tone and then how to develop the implementation strategy.

Turnaround Tip: Be sure that your team knows the score, the down, the yardage, the yard marker and the time remaining.

Phase 2: Developing the Plan – the Recovery Phase

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The development and implementation of the Turnaround Plan as you recover and rehabilitate really has 3 phases (Doug Kelly of Pelorus Group in Chagrin Falls, OH first summarized the process this way for me). Each phase is outlined below.

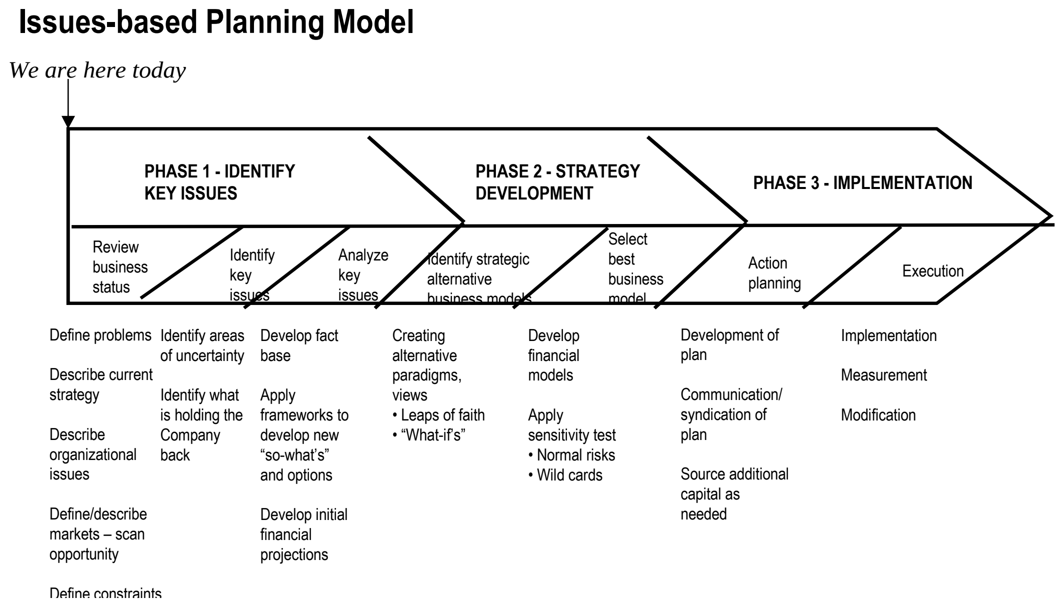

Exhibit 3

The major emphasis of Phase 1 is to identify the major issues in the business that are causing problems and must be resolved (for our purposes here, I define issue as "meaning that resulting from a circumstance"). As you go through this phase, think about what caused the current situation. And then what has been the impact of the situation financially, operationally and organizationally. Compare your income statement, cash flow and balance sheet over the past three years as well as any key operating measures over that period. Take some time to analyze what has happened and then force yourself and your team to identify and rank the biggest issues before moving ahead with trying to plan to solve them. My reason for focusing on the issues makes the team deal head-on with what is most important and maybe most distasteful about the current situation. Your role as leader or senior member is to make sure that this frank analysis and related discussions occur. At the end of Phase 1, the team should have prepared a list of the most important issues to resolve and also the impact on the Company if they are not. Some additional tools to help this analysis include:

- *Lost customer analysis (LCA)* – interviewing lost (former) customers and determining why they left, what problems they saw, and how could they be wooed back – also interview a sample of current customers.
- *Market analysis* – looking outside the business to evaluate market size and factors affecting it now and in the future.

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- *Customer analysis* – trends, concentration, profit by customer or customer groups
- *Cost of poor quality (COPQ)* – the cost to the business of having to do things twice such as of rework, cost of scrap, of customers having to call back to follow up on an order
- *Lean operations analysis* (based on Japanese concepts) - use them (I am sure you have read about many varieties of these techniques) to evaluate the amount of assets you carry, including inventory, equipment, real estate and receivables

This data collection and analysis resulting in determining the key issues should not take more than a couple of weeks of determined effort.

Turnaround Tip: Use an outside consultant to help objectively assess your business, it is hard to do it yourself because of bias and not having enough time.

An Aside about Cash Flow as Part of the Turnaround Plan and Survival

I discussed earlier how important cash is, not just to pay the bills but also to determine the value of your business? What do I mean when I use the term cash flow? It is a combination of the activity of your business that is represented on your income statement and also on your balance sheet. It is the cash flow before debt service payments for interest and principal that sophisticated investors use to value a business. Here is an example of calculating that cash flow.
Uniform Cash Flow
Exhibit 4

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You can see this company is troubled

	January	February	March
Sales - Net	378,108	291,388	125,000
Change In Receivales	(101,181)	(25,764)	113,251
Cash From Sales	276,927	265,624	238,251
COGS	(355,422)	(324,202)	(291,802)
Depreciation	5,833	5,833	2,083
Change In Inventories	24,482	32,268	66,114
Change In Payables	(169,042)	64,699	16,316
Cash Production Costs	(494,149)	(221,401)	(207,289)
Gross Cash Profits	(217,222)	44,223	30,962
SG& A	(20,000)	(20,000)	(20,000)
Change In Prepaids	983	983	983
Change In Accruals	17,323	41,494	(144,541)
Change In Operating Deposits			
Misc. Transactions			
Cash Operating Expense	(1,694)	22,477	(163,557)
Cash After Operations	(218,916)	66,700	(132,595)
Income Taxes Paid	-	-	-
Net Cash After Operations	(218,916)	66,700	(132,595)
Interest Expense	(17,704)	(17,868)	(10,307)
Total Financing Costs	(17,704)	(17,868)	(10,307)
Net Cash Income	(236,620)	48,832	(142,902)
Current Portion LTD			
Cash After Debt Amortization	(236,620)	48,832	(142,902)
Capex - Tangible			
Cash After Capital Spending & Investment	(236,620)	48,832	(142,902)
Financing Surplus/Requirements	(236,620)	48,832	(142,902)
Change in LTD	-	(29,917)	(1,047,488)
Change In Equity	(20,851)	(76,516)	690,808
Total External Financing	(20,851)	(106,433)	(356,680)
Cash After Financing	(257,471)	(57,601)	(499,582)
Actual Change In Cash			
Net Income Plus Depreciation (Gross Cash Flow)	(230,787)	54,665	(140,819)

This example is illustrative, only.

You prepare this schedule from your balance sheet (which shows how different asset and liability items change) and your income statement (which shows how your company fared with respect to revenues and gains compared to expenses and losses for the period). The format of this cash flow schedule is different than the normal schedules your accounting people put together. It is called the *Uniform Cash Flow* and is relied upon by lenders and by you also because it clearly indicates the priority of cash payments, first for operations, taxes and then for debt service. In this case, the chance of the lender being repaid in March appears to be nil since the Company has negative cash flow of $132,595 before any debt service. You should also use this format for analyzing and presenting your business' cash flow. Remember, for every dollar of cash flow to be generated by your business, its value to its owners increases by at least 5 times.

You may benefit from a brief analysis of the *Uniform Cash Flow* report to get a better understanding of the dynamics of cash and how a lender would look at it. Let's focus on March. In March, the Company had Net Sales of $125,000 and Change in Receivables of $113,251. Since this schedule analyzes changes in cash in the business, this positive change results in cash coming in so means that Receivables were collected or decreased during the period. Total Cash from Sales was $238, 251.

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In the next section, COGS (cost of goods sold) was ($291,802). Depreciation was $2,083, since it is not a cash disbursement it is added back to our schedule as I work to calculate the cash flow for the period. The Change in Inventories was $66,114, meaning that inventories dropped by that much. Finally, the Change in Payables was $16,316, reflecting an increase in Accounts Payable due to vendors giving the Company additional credit. The net result of the change in these income statement and balance sheet accounts was Gross Cash Profits of $30,962 for March.

The next section accounts for the costs and balance sheet items related to Company overhead to produce those cash profits above. SG & A (Selling, General & Administrative) Expenses were $20,000 for March. Balance sheet account changes related to overhead included Change in Prepaids of $983, Change in Accruals of ($144,541). This change reflects that Accrued Expenses (a liability account) were reduced by this amount, meaning that cash was used to pay those accruals (for taxes, etc.). Those accounts reflect Cash Operating Expenses and subtotal to Cash after Operating Expenses of ($132,595).

After that subtotal, I subtract interest expense and debt principal payments to equal Total Financing Costs. In this case, as I mentioned above, since Net Cash After Operations is negative, there is no cash to pay any of those expenses or payments. This section is critical to a lender's review and analysis since it indicates whether they will be paid. The remainder of the schedule indicates some additional balance sheet changes.

Turnaround Tips: Cash is King.

Phase 3: Revitalize Your Company

"Turbocharging your business" is a phrase my coauthor and I coined a few years ago to describe the process and the result of getting your business to perform its very best (from Goddard, Larry, and Brown, David, *The Turbocharged Company*, Shaker Heights, OH, York Publishing, 1995). We wondered back then why in almost every industry there seemed to be one company that dramatically outperformed its competitors from a value creation to shareholders measure (Return on Equity). We identified these high performers and then analyzed (through interviews and other means) why they were so good. You will be able to use what I learned as you work through your effort of building your plan. Let me summarize for you the basis of what I learned.

The best companies succeeded because they adhered to four foundations of performance and leadership. They pursue each with equal fervor since the Company's success depends on excelling in each foundation. The first foundation I have already referred to and described above, *Unleashing People Power*. The second is *Revering Your Customer*. This foundation encompasses many factors but primarily is viewing the customer as a source of a relationship that will continue not merely a one-time transaction. This view is very pertinent now because of the increasingly high cost of attracting customers (whether consumers or business). You may be thinking that the cost of pursuing these two

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foundations makes them impossible to consider in a time of trouble. Not really, since much of the excellence in these two areas stems from attitudes and not from investment. However, the next foundation does clearly incorporate expense and asset allocation factors.

The third foundation was originally described as the *Relentless Pursuit of Efficiency*. I have now changed the word *Efficiency to Effectiveness*. No one cares if you are efficient but do not achieve the goals needed. That measure of achievement is effectiveness. The final foundation is that the most valuable companies I identified *Dominated a (or several) Market Niches*. They were the leader in each market segment in which they competed.

To reiterate for you, the companies with the best returns to their investors excelled and continued to strive for improvement in each of these foundations. They viewed their success as due to following a system of pursuing each foundation. For example, without unleashing people power a company cannot relentlessly pursue effectiveness. Why? Employees who are not motivated and do not care will not try to focus on effectiveness and therefore profitability.

An example of my belief that business success is due to focusing on all 4 foundations is the success that Jack Welch of General Electric has had. While so much has been written about he and GE and his management approach, no one has been able to replicate his success by merely reading the books and copying what he does. The reason is that in addition to performing certain measurable, quantitative tasks, his success is due largely to the "qualitative" (the non-technical) work he does. The selecting of people, working with them, coaching them and learning from them is the real core of his and GE's success. Without both the *quantitative and qualitative systems* and processes he would not be successful. You and your team must consider and develop plans to succeed and improve in each foundation area. As you go through your planning process, in both Phases 1 and 2, use this Turbocharging model and a stimulus to reflection and goal setting.

Turnaround Tip: Follow the system of Turbocharging to ignite your business to success

Transformation of Your Company – more than Recovery, Rehabilitation

Rehabilitation here means to bring to an optimal state of health or performance. That is what you and your team should be striving to achieve.

So far, I have covered for you, frameworks to use for the Survival and Recovery phases of your turnaround. But I think you and your team want more than to recover to where you were before your Company became troubled. In this section, I will give you some specific recommendations regarding how you and other leaders in your Company can move it to be able to achieve the turnaround you desire. These recommendations are management-oriented, rather than planning related.

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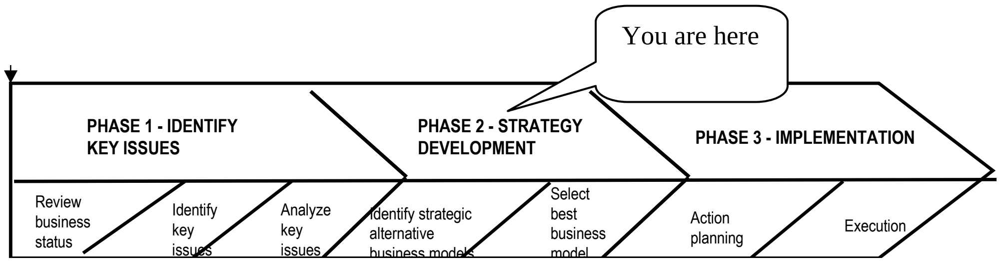

When your Company enters that Emergency Room and you and your team begin to work on it to save it, you have a high sense of urgency. However, it is a reality that not everyone has that same sense of urgency or perspective that you have. Based on a chart that I use, here are the steps you should follow.

1. Establish a sense of urgency – but not of panic. Tell it like it is, examine and describe reality.
2. Form a powerful guiding team – who has a desire to change and the power to do so.
3. Create a vision – be able to describe it in 30 seconds at a barbeque. It should include a quantitative goal for profitability and business value as well as a qualitative vision of the Company; for instance, I will be the best carmaker in the world (Chrysler in the early 1990s).
4. Communicate that vision – if no one knows it, it does not have much impact.
5. Unleash people power – no more is needed to be said (I hope!).
6. Plan and achieve some short-term wins.
7. Develop a comprehensive plan with clear milestones.
8. Get the best people possible, make the tough decisions and move on.

Turnaround Tips: Pay the money to find and hire the "A" players (employees). You will not succeed without them.

Writing the Turnaround Plan and its Durability

I have discussed extensively above different aspects of the Turnaround Plan for your Company. I have covered how to develop it, the factors and questions you and your team should consider. Also, who should be working to develop the plan as well as its audience. You need some additional practical recommendations on content and also on the durability of the Plan.

By durability, I mean the time that the Plan should remain in effect. In my experience, the best managers are constantly, explicitly measuring their performance against plan, challenging the assumptions of the Plan and continually looking for ways to improve through modifying the Plan. Especially in the crisis and fast moving environment of a turnaround, the one constant is change and unpredictability. You and your team must be very flexible and quick footed to adjust to those changes.

The content of the Plan should answer the following questions, concisely and clearly:

- What happened, what caused the Company to end up in this situation?
- Why did it happen?
- What is the impact today – financial, operational and organizational?
- What are you going to do?
- What is the financial impact – in projections, showing on different creditor groups (secured creditors, unsecured, vendors)?
- What are the risks?
- What is the timing?
- What are the measures?
- For the parties to whom the Company owes money, how does their supporting this plan help them? Bluntly, how is their position being improved?

The plan should start with a 1 page executive summary. The summary should clearly describe your vision for the Company and its turnaround. Then add a few pages of little narrative and summary projections. The audience can refer to numerous appendices for detailed projections, market and customer analysis, production analyses, liquidation values, asset sales and their proceeds and other important schedules. Remember the audience is diverse including lenders, other creditors and your employees. You may decide to prepare several versions of the Plan tailored to each group.

Turnaround Tip: Be sure that the plan is closely based and related to what happened in the past.

Implementation – Achieving Success

Chuck Ames, former CEO of Reliance Electric, BF Goodrich and now a principal in a large buyout firm, has said that the quality and depth of the implementation plan is the most important part of the strategy development process. I completely agree. This part of the turnaround is where real management and leadership skill is meaningful. Below are a few tips for an effective implementation plan:

- Include as much detail as needed
- Format it in Microsoft Excel or another software package so you can easily edit it
- Have clear responsibilities
- Have clear deadlines and milestones
- Meet frequently to measure progress (at least weekly if not daily)
- Delegate
- Communicate the plan widely – inside the Company and of course, to your lenders and other interested parties

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- Do it as quickly as possible

Turnaround Tip: Go as fast as possible.

Final Words

Turning around a business is very hard work and it is very difficult to be successful. However, the recommendations in this brief will dramatically improve your chances of success. Please remember to keep your business's problems and your efforts in perspective. Its problems were not the result of only a few people's mistakes and neither will its turnaround be the result of only a few people's efforts.

David Brown's Biography

David is the Managing Director of Red Hawk Associates, Ltd. Over the past three decades, he has specialized in helping management and other stakeholders resolve business issues of strategy, organization and operations. Many of his clients wish to transform their businesses, leveraging off new selling channels. His clients range from the middle market to the Fortune 500. Some of his assignments are related to turnaround consulting, turnaround management and investment banking related to selling or refinancing troubled businesses. In addition to advising clients, he was crisis manager of a troubled $165 million fabricator and distributor.

David has advised or been referred by numerous lenders and equity sponsor groups including Bank One, National City Bank, Key Bank, Huntington Bank, Star Bank (now Firstar) and Foothill Capital.

David co-authored The Turbocharged Company which Bernard Marcus, CEO of the Home Depot, described as "logical, well-thought out and proven in organizations across America." He holds an M.B.A from Carnegie-Mellon University and a Bachelors of Science in Economics from Georgetown University's School of Foreign Service. He has worked in more than 60 countries and speaks proficient French. He is or has been a member of a number of boards including the Turnaround Management Association (he is one of fewer than 250 Certified Turnaround Professionals). He is the Immediate Past President of the Ohio Chapter of the TMA. David is also a trustee of the Ohio Venture Association.

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