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Looking for the Best Outcomes... Early Warning Signs of Troubled Companies

By Megen Donovan

In a Q&A with ABF Journal, Carl Marks partner Joe D'Angelo discusses some of the many warning signs of trouble that companies face, including liquidity crises, negative performance variances, delayed monthly reporting and others. Ultimately, he says timing is critical — if you have more time, there will be more options and alternatives to improve troubled businesses.

ABFJ: Why is liquidity the pivotal issue in restructuring?

Joe D'Angelo
Partner, Carl Marks Advisory Group

JD: Liquidity is the life blood. If a company doesn't have enough liquidity to keep buying materials, manufacturing goods and shipping orders, then we're not going to be able to create cash to make payroll and keep everything together. It's just that simple.

The company needs to create opportunities to increase liquidity. You want to establish core versus non-core items. You have to identify and evaluate the sacred cows. It's the difference between keeping the patient alive and sucking it dead. If you can identify non-core assets that have value, that's a principle way to create liquidity.

Business process improvements create delays in cash conversion. You often hear "that's the way we've always done it," and that should key you in that this is an area where you should look. If you can preserve the going concern and the enterprise, you'll have a better outcome. You really want to avoid liquidation because it is typically going to get the lowest recovery.

So by increasing liquidity and extending the runway, you're giving yourself more time. Time is critical. If you have more time, you have more options and alternatives. If you have more options and alternatives, then you can improve the business. It will lead to a better ultimate outcome.

ABFJ: What are areas for improvement in performance reporting?

JD: The most common problem is a lack of reporting; most companies close the books every month (i.e., financial reporting). However, financial reporting is backward looking. You don't often see best practices in terms of operational reporting.

We implement a 13-week cash forecast so the client can manage liquidity. But we also work with management to develop a one-page dashboard, which includes financial and operational metrics. The dashboard 1) helps align the leadership team so everyone is looking at the same set of data, measurements and results, and 2) keeps everyone focused on what's important and establishes leading indicators in the business so they can address issues sooner. We also like to use a bridge analysis of budget to actuals, which typically helps you identify the variances in volumes, product mix, price, margin, etc. and isolate why you are missing the budget.

ABFJ: Please comment on how a delay in reporting could be an early warning sign and what options there are to potentially avoid defaults.

JD: The ABL document will have both affirmative and negative covenants and reporting requirements, including monthly reporting. The delay in of itself could be a default. There could be a number of things going on, such as: turnover in the accounting staff; a technical problem; or they are doing systems cutover.

The worst explanation is when the company is trying to buy time before disclosing something negative. That's the bad news, and that's what is very worrisome.

If there is a default, there are a number of ways of dealing with it. If the lender is engaged proactively, a default could either be avoided in the first place or it could do a waiver, forbearance, a standstill or an amendment.

If we take the situation where something is amiss, we develop a fact base from accurate and reliable data: What are the issues, what are the contingencies? What does the data imply? Once we have a fact base, you can start to develop options and alternatives, and make recommendations to both sides. The fact base allows you to reach some consensus. If people are just arguing that the data is wrong, it's problematic.

ABFJ: What does flat revenue on higher volumes mean for companies' competitiveness?

JD: It's not a good sign. Flat revenue on higher volume is something you'd see in more commoditized businesses. Sometimes it could mean the customers gain some buying power. It definitely means the company is experiencing pricing pressure. You see a lot of consolidation in businesses just to be able to gain more buying power in negotiating their prices. Sometimes the company is reducing its price because it's not as competitive as it needs to be in terms of quality, so it has to sell on price, which is a bad sign.

When you're selling print advertising and your customer base is moving towards digital, like Yellowpages and directories, the way digital advertising is packaged and priced, you would need to add three digital customers just to make up for the profit contribution of one print customer. Digital ad solutions have a higher profit margin as a percentage but the absolute dollars are less. It's not a good sign. You would typically expect to see a company in that situation losing market share.

ABFJ: Please comment on eroding margins as they apply to certain industries, such as shipping.

JD: Because shipping is traditionally a strong industry, we've seen lenders by and large acquiesce toward amending and extending debt, but the drivers were pretty fundamental, such as cost of fuel. When cost of fuel went up, most of the shipping contracts had a limited ability to pass through the increase as a surcharge. Most shipping companies had to absorb the increase, which created a lot of downward pressure on margins. The second impact was the slowing demand from China, which came in three forms:

Oil and gas shipping (tankers) — slowing demand for energy from China affected tankers.

Bulk shipping (coal and iron ore) — when the building demand began to slow in China, it negatively impacted bulk carriers as well.

Container carriers — the slowing demand in China was a direct impact on price. What exacerbated this was when the sector was healthier, most industry participants ordered larger, more efficient vessels. However, there is a glut of capacity, and there weren't an equal amount of boats that were being retired and taken out of service.

So with the glut of capacity, reduced demand and the pressure also from fuel, margins have gone way down.
ABFJ: Please give an example of companies that needed to adapt to technology changes in its market.

JD: We know of a situation involving a medical device company that made a hardware/software device to help individuals with speech impediments. It sold or leased its solution for $3,500 at the low end; at the high end it was upwards of $6,500-$8,500. The iPad, which only costs $500-$1,000, cleaned the company's clock because it has a free app that provides 90% of the same services. The company didn't react soon enough and it needed to develop other elements, services and capabilities to differentiate itself from the iPad.

Another example is RadioShack in the advent of smartphones. RadioShack customers used to go in there and buy a GPS, an mp3 player and a clam shell phone. Now they just buy a smartphone; they don't buy the other two things because smartphones do everything. RadioShack didn't see that soon enough and change not only what it's selling but how it's selling it. That is one of the biggest thorns for RadioShack. It makes a lot of money selling smartphones, but smartphones cannibalize its other products.

ABFJ: What are some risks and solutions involved when write-offs, canceled orders or bad press are reported?

JD: Write-offs and canceled orders are a red flag because the loan advances are supported by a borrowing base. If the receivables or inventory had write-offs or canceled orders, there is likely to be a negative impact on the borrowing base, which may mean that the lender is overextended against the eligible assets.

Bad press could be related to a write-off due to a customer canceling an order; alleged dishonest practices; a product issue; or a regulatory issue. We need to assess the impact on the borrowing base. How much money do we have loaned out and what are the eligible assets against it? If the bank is overextended against the eligible assets, then we have to work to figure out how to bring that back in line.

A lot of companies dealing with bad press, especially in the middle market, are less prepared to deal with it in a public relations way. To just go radio silent is not a good thing. We want to understand the communications plan, what is being said, how it's being said and delivered, and what expectations are being set. Anytime you have a negative event, it can be a bit of a triage, so you need to make a quick assessment and maximize communications, and then very quickly assess liquidity — it's always going to be liquidity for us because if you run out of liquidity, you're dead. We want to make sure the patient still has enough blood for us to figure out a solution and implement it.

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