When It All Goes Wrong

David C. Castaldo

No one ever starts a business thinking about what to do if or when their business gets into trouble. However, when it does happen, time is the one thing that you will have the least of. Pressure will be exerted from many directions. Your bank, vendors, employees, and of course your investors will all have questions and concerns. It can be quite overwhelming the first time you see it happen, and if it is the first time then get some help. This is not the time for on the job training.

What You Can Expect

If you do end up in this situation you are in one of two groups…those who saw it coming and those who didn't. If you had forecasting and measurement systems in place you may have received a warning from those systems that trouble lie ahead. If not, you may have sensed it but not fully appreciated your situation until cash flow problems surfaced.

Which group you fall into will have an impact on the outcome mainly due that very expensive resource …time. The farther down the failure timeline a company finds itself before the problem is identified, the higher the probability of a business failure. Regardless of the timing, the steps to be taken are almost identical, although they may be addressed in a different order and with a different degree of aggressiveness.

When caught early you have time to try to correct the problems before the company finds itself in serious cash flow difficulties. When not caught early more drastic actions are usually required to stall the failure.

Markets drive business. Therefore, a market centric approach to business turnarounds provides the best opportunity for a long lasting recovery. You cannot turn around a company simply by cutting costs. Only increased revenues generated by an aggressive sales and marketing effort and/or a retooling of your product or service offerings can provide the long-term fix required to reestablish the business as a successful going concern. Since business success starts with customer demand and satisfaction, information collected from market research and customer satisfaction surveys will prove extremely valuable. When to perform those analyses depends, of course on where the company is on the failure timeline.

Brother, can you spare a STAMP?

Begin by undertaking a rapid assessment of the current situation. Three specific areas of focus are the severity of the company's financial condition, the abilities of your management team, and any market, product, or service delivery crises.

Financial assessments should be conducted including a thorough analysis of cash flow, borrowing facilities and lender relationships, reporting and control systems, and capital structure. An evaluation of the performance of each of your key management team members should be conducted to alert you and your advisors to any deficiencies which may impact the outcome of any turnaround efforts. Finally, on a case by case basis any product or service that is experiencing any type of market crisis should be evaluated. These include crises emanating from competitive issues, product quality or performance issues, and those that are the result of the current economic failure of the company.

A failure at a company escalates at an almost exponential pace with problems seeming to feed upon themselves fueling even greater issues. These problems rarely can be concealed and it is inevitable that customers, vendors, and creditors will hear about the difficulties at the company. In fact, attempts to conceal problems usually fail and lead to even greater confidence problems from

Key Items in The Short Term Action Management Plan

1. Stabilize cash flow.
2. Align costs with current revenue levels.
3. Assess personnel problems at all levels.
4. Develop and control the message regarding the company's problems.
5. Meet with key employees to avert loss of investment in talent.
6. Meet and develop arrangements with key creditors.
7. Meet with key customers and prospects.

those same constituents. Therefore, managing the message becomes critical to the turnaround effort.

Let's look at a tool that has been used in numerous assessments, a seven step Short Term Action Management Plan (STAMP). Recognizing that the goal of this assessment is to create actionable items without the time for a thorough evaluation, only the most critical issues are dealt with in the STAMP.

Converting a conference room to a war-room can be very helpful at this stage. It will provide a central place for meetings and help to focus the team by creating a base of operations for the turnaround effort. Expect the walls to become covered with charts, timelines, task lists, and other helpful items. This is one time paper is superior to electronic forms of display. Also, be sure the room is equipped with blackboards or whiteboards, and screens for displaying presentations.

Triage…Stop the Bleeding

Depending upon the stage of the company's failure, the STAMP may include certain remedial action items which could include workforce reductions, management changes, or other cash saving actions. Although non-staff reductions are considered, true cost savings usually require a workforce reduction with corresponding improvements in efficiency. Your company needs to learn to work smarter and to do more with reduced resources. Obviously these actions should be taken first to conserve cash. However, be certain that you have taken all the staff reduction actions that are required. Continued reductions in force will lead to collapse of morale and a rush for the exits by your best employees. Any further staff adjustments should be due to job performance.

Only an accurate conservative cash flow projection can provide the information you need to make the correct decision. The first step in preparing this cash flow projection is to understand the current expenditure and revenue levels. It is wise to rely only on the known and disregard the promises of new revenue sources.

Once any required actions to stabilize cash have been taken, you can begin a more thorough review of personnel to be certain that all key positions are staffed with capable individuals up to the tasks that lie ahead. You will need the best you can afford at the top financial and marketing positions. Also, an experienced operations executive that understands how to run an efficient production or service delivery system can be critical to your turnaround plans. Beware of the manager who is constantly complaining that his or her department is understaffed. Of course it is understaffed, that was the action required to put the company in a position to recover from previous periods operating at spending levels that exceeded revenue levels. Also, be certain that your key executives and managers are personally committed to the company, since long hours are to be expected. Get their commitment or suggest that they exit now. For those that commit establish short and long term reward programs. Usually, these are equity-based compensation arrangements. However, small cash based rewards that can be factored into a safe cash flow projection can be immensely helpful in maintaining morale.

Finally, you need to control the message at multiple levels. This includes staff, customers, creditors, and investors. If you fail to take an aggressive position in managing the conversation regarding the company's condition, other parties will define the message for you. Internally, the rumor mill will be active and both innocent and malicious conversations will begin to flow. Within customer groups, rumors will also begin regarding the survival of the company, and competitors will use these rumors to their advantage. Creditors, including your bank, will become extremely concerned and may take actions detrimental to the company's future. Finally, investor confidence must be affirmed.

Beginning internally, your staff needs to know that the management team is in control and has a plan to stabilize the company and chart a course to future success. Transparency and forthrightness is the most important issue in dealing with employees. Keep your employees informed; be truthful but not excessive in your dissemination of information. You must build confidence with the staff and begin to rebuild your team. A superficial approach to this endeavor will be obvious to your employees. Keep alert for employees working against the company's best interest and take appropriate action swiftly. You need to reach into your organization and provide opportunities for your best to rise to the top. Create opportunities and paths for your staff to contribute to the turnaround of the company.

Your customers remain the lifeline to your efforts to rebuild the company. Members of your top management team should meet with key customers to inform them of events at the company. Customers will be concerned with the risk that the company will not be around to support the products they purchase. Your message must instill confidence that the company has already turned the corner on the road to recovery and that the management team is committed.

Creditors will fall into one of two categories: structural lenders and vendors. Among your possible structural creditors are your banks, and senior and subordinated debt holders. General credit vendors have little interest in providing continued credit terms when the risk of default increases. You may find that terms with some of these vendors will revert to cash-on-delivery or even payment in advance and you should factor this into your cash planning. Vendors who have a vested interest in your company such as those that provide components for your products may be more agreeable to providing continued terms. You will need to meet with these vendors and assure them of the value in a continued relationship. Some vendors will use this as an opportunity to obtain a higher price or a stronger commitment from the company regarding future business. Be certain that you are prepared for these events. Make sure you understand how important each vendor is to your turnaround plans and negotiate accordingly.

Managing investor expectations is critical when executing a turnaround. Disclosure of the issues is paramount at this stage. You need to build trust as well as confidence. Do not attempt to “sugarcoat” the issues facing the company or purposely lower expectations in order increase your upside. Investors understand the tough issues facing you. Be forthright and honest in your assessment and provide your most insightful analysis. At this point they know you only have limited information since you have yet to conduct your more extensive investigation and analysis.

Expanding Your Knowledge

Now that the fires are under control you need to extend your analysis by obtaining information outside of your company. As you complete the evaluation of the company and its products, you need to confirm and extend the information collected internally with validated external sources. The most significant of these are a survey of existing customers and a study of the products, markets and competitors of the company.

Customer surveys are critical in determining how well the company is satisfying its customers’ needs. The design of this survey should be performed by someone on your team experienced in survey design and executed by a third party to ensure that customers are not afraid to provide an honest assessment. Two of the key issues you want the survey to probe include: (1) are the company’s products and services providing the customers with value; and (2) are customers satisfied with the quality and delivery of the products or services. Negative responses in these areas are clear indications of action needed in your turnaround plan.

Market research is a tool that provides you with information on your products, markets, and competitors. It provides information to help with product design, communication with customers, choosing selling methods, and accurately projecting future sales. In a turnaround you are evaluating whether your products and services are meeting a markets desire based upon their features and functions. The information collected also helps determine if the company is using the best method to communicate with each specific market, and the best way to inform customers of your product or service benefits. It also provides you with the knowledge to determine the best method of selling your product or service to potential customers. Finally, it can provide you with information on market size, trends, pricing levels, and price sensitivity.

Market research is critical in providing third-party confirmation on market potential that is needed when preparing your turnaround plans. Without market research, financial projections have little value since the revenue estimates and pricing assumptions are nothing more than your opinions. Market research also provides you with the knowledge necessary to develop the strategic objectives and sustainable marketing plans for short-term and long-term planning. When required, you may need to extend these analyses to the development of a requirements analysis to confirm existing designs or provide the basis for new development. The purpose of this requirements analysis is to ensure your product designs or service offerings meet with customer needs and expectations.

Since these studies provide such critical information, your management team must be actively involved with the study design. Without reflecting a clear understanding of the firm and its products or services, the study cannot be designed or executed properly.

When you have completed this work you should possess a document that explains market size and trends, provides a complete competitive analysis, enumerates the strengths and weaknesses of the company in the market, identifies threats to the company's market position, and provides an understanding of factors affecting industry profitability.

It is important to not lose sight of the overall objectives of this process which are to: (1) develop the knowledge and market intelligence necessary to make informed business decisions, (2) develop consistent long-term market strategies and (3) help the company develop an overall unified mission—one that differentiates the company and defines the direction of the organization.

Looking Inside

Your next investigation should be the internal operations of your company - sometimes called the business infrastructure of the company. Business infrastructure encompasses most of the functional domains of the company and encompasses the processes, procedures, documentation, and staff of the company. When you are selling your company it embodies the value you are conveying to the buyer. A well-developed business infrastructure protects a company and its investors from the risks of having too much of the company know-how in the heads and hands of a small number of employees of the firm.

When conducting a restructuring or turnaround, this often involves not only changes to business methodology but may also involve changes to management personnel. Globally, business infrastructure is defined by inter-departmental processes, communication and workflow. You should review all of the firm's policies, procedures, and work instructions. Often you will be required to create missing documents and revise inaccurate ones. In addition, you should look for inefficiencies in work production and workflow. Accuracy in communications should be examined with the objective of ensuring accurate and timely flow of information.

Key areas for investigation include your marketing and sales infrastructure, production or service operations, and the administrative function of the company.

Marketing infrastructure encompasses the research, strategy development, and promotional functions of the company. Many small companies have not invested in developing the internal expertise necessary to develop an effective marketing infrastructure and will require extensive work to create this capability.

Sales infrastructure includes the organization of the sales effort, how its efforts are measured and results judged. Many small growing firms have relied on non-professional sales personnel to bring their products to the attention of potential customers. Often these are the same professionals that have engineering, production, or general management responsibilities. You will need to evaluate your company's personnel and practices and develop a focused effective sales team.

Finally, you need to evaluate the financial, accounting, and human resource functions of your company. You should review current data collection and reporting methods and systems. Also, evaluate measurement systems and objectives for the purpose of ensuring information provided to management at all levels reflect the actual performance of the product, product line, or business unit. Next, assess the effectiveness of the planning and forecasting tools to determine if they are appropriate for the firms industry, size, and capabilities.

You should also conduct profitability assessments and cost structure evaluations. Many small firms utilize accounting systems that only provide financial results. This information is useful when providing information to banks, stockholders, and in preparing tax returns. However, in many cases these systems are not capable of providing management information useful to assess product line or business unit performance. Therefore, this task may be more difficult and may involve extensive investigation and analyses. Regardless, a thorough financial analysis is required in order to fully understand the potential outcomes and justify any continued investment.

Efficient management of cash flow is critical to the success of any organization, especially those in distressed situations. A stable well managed cash flow can increase the confidence investors, lenders, and vendors have in the management of the firm at this critical time. You should inspect every aspect of the business to determine how cash is generated and where it is absorbed. This assessment should begin at the sale and continue through inventory acquisition, manufacturing or service delivery, all the way through the cycle to the collection of receivables.

Many companies have ineffective forecasting methods and therefore have significant difficulty in managing their cash position. Cash flow forecasting is one of the most important tools used by financial executives and accurate forecasting will provide key data on cash surpluses and deficiencies. Proper forecasting ensures that revenues will cover product and operating costs and, as a result, can identify cash requirements months in advance. Therefore, borrowing or investment requirements can be identified and quantified before a cash crisis develops. In some cases you may need to develop or acquire completely new models to ensure accurate and consistent cash forecasting.

Assessing the company’s infrastructure and planning and executing changes to that infrastructure should be an important part of your restructuring efforts. It often involves a re-engineering of the company's processes and a rationalization of its operations to maintain cost reductions achieved upon implementation of the STAMP.

You should now have the information you need to complete the turnaround plan document. This document provides both a general course of action and specific goals and timelines presented in a manner that provides management and directors with actionable items.

The Right Man for the Right Time

You have been the driving force behind the growth of your company; the products of the company may even be your brainchild. But are you the right person to lead the company through this crisis or even through its next stage of development. It is not unusual for the founder of a company to find themselves in a position where they are uncertain with how to confront the challenges facing the company.

If this is where you find yourself, it is time to talk to your trusted advisors. If you have a Board of Directors you should approach them first. They may have already begun the conversation and will welcome your willingness to put the question on the table. You should determine in advance whether you want to remain with the company under new leadership, or if it is time to exit and assume a non-management role. This exit sometimes takes the form of a consulting relationship. In cases where you hold a significant share of stock in the company, you may elect to remain on the board and oversee the actions of the new management team.

If you intend to remain then be prepared to hand over full control of the company to the new chief executive. They will not have much chance of success if they have to clear every decision with you. Most likely an experienced executive would not have taken the position in the first place without obtaining that understanding in writing in their employment contract.

Implementation

The next phase is to implement the turnaround plan. One of the items addressed in the plan is an assessment of the management team and key personnel. If deficiencies were found then this should be your first course of action. Successful companies are about successful people. Make your changes now; any delays in making required personnel changes will only complicate your turnaround efforts. If further staff reductions, beyond management, are necessary then make those cuts immediately.

The action items specified in the plan should be assigned to specific managers with appropriate timelines and success measures or “scorecards”. The items in your STAMP should remain at the top of your list. Issues such as cost rationalization and cash flow stabilization should receive much of your attention at this stage.

A sense of urgency must permeate the company. Both management and staff must understand what their role is and when they are expected to complete assigned tasks. Conduct weekly meetings to review progress on key objectives. If you have not yet setup your war-room, you should consider establishing one now. Make sure that you post the charts, timelines, task lists, and similar items on the wall where team members are constantly reminded of your progress.

Keep all of your constituents apprised of the company’s progress. Consider establishing a regular monthly report for internal stakeholders. This should be prepared in sections that recognize that different groups should have access to varying levels of information. Also, be certain to maintain open lines of communication with key vendors and customers.

Fund Raising

Deteriorating financial performance often results in what is commonly called “lender fatigue” which inevitably leads to pressure on funding availability. Declines in the company's net worth brought about by rising debt and declining profits can result in the company's current lender becoming uncomfortable with its position. This can result in the company’s business being assigned to the “work out” group of the lender. The purpose of this group is to retrieve the bank’s funds using sometimes aggressive techniques. When a lending institution has reached the decision to assign the company to this group, it is necessary to actively seek a replacement source of funding. This is often the most difficult time to refinance debt. You will need to identify and communicate with providers of debt and equity financing that may be more suitable for the company’s current financial position. This may include the requirement to prepare a Refinancing Memorandum, identifying prospective capital sources (including mezzanine debt and equity, if appropriate), present to lenders, and negotiate term sheets. If your financial team does not have significant experience in managing these issues, then you should seek external help from the appropriate professionals.

Not Everybody Makes it out Alive

Be prepared for bad news. Sometimes the assessment concludes that operation of the company as a going concern may not be feasible, and alternative courses of action must be identified. These alternatives could include sale of the company, sale of all or most of the company's assets, reorganization under Chapter Eleven, or dissolution under Chapter Seven. These subjects are beyond the scope of this article and you should obtain outside counsel when confronted with these potential outcomes.

Mr. Castaldo has been a member of management teams in both growth companies and company's experiencing financial difficulty. Within these organizations he has served in numerous roles including Chief Financial Officer, Chief Operating Officer, and Chief Executive Officer.