Spotlight On...

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Business turnarounds

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Alan Tilley of Bryan Mansell & Tilley, considers the rise of the Chief Restructuring Officer (CRO), a temporary executive function which aligns its fiduciary duties with those of the directors, in business turnarounds

In a market economy there will always be business failure. That is an essential part of the capitalist system. Market dynamics drive change and businesses either react to change and survive, or die. Failure to respond to changing circumstances can drive a business on a decline curve, which can lead to financial crisis.

Businesses do not fail through lack of profit but through lack of cash. As a crisis deepens, stemming the tide of cash haemorrhage becomes more difficult. Losses mount, customers and key employees jump ship, suppliers tighten credit terms and financial creditors seek to reduce exposure.

Denial and lack of change in management direction has a significant bearing on business distress. Business turnaround in distress is an exercise in crisis change management in conditions of extreme liquidity pressure. It is a situation that requires specialist skills to resolve.

CHANGE IS GOOD

Organisations, like the people in them, are naturally conservative. The default position is to resist change. The majority have a vested interest in the status quo. Most businesses are culturally resistant to changing circumstances. If this is not addressed by change from the top the company will decline until a liquidity crisis arrives. And when a crisis does arrive management usually lack experience of how to handle it.

At this stage, efforts to stem the financial pressures divert management away from essential operational management. Management request a little more time and a little more money. But in a crisis time and money are the two things in short supply. Change is essential but what to change and how? A financial crisis is no place for on-the-job learning. This is time to seek professional help.

IN DENIAL

Faced with a tax problem or an IT problem, management will have no qualms at hiring professional help. Faced with declining performance, management see seeking assistance as a slight on their management capability. But, faced with changing conditions, today's lean management structures are rarely equipped with the breadth and depth of resource to implement change.

It is no reflection on ability to seek help. On the contrary it is a sign of management strength to recognise its own collective lack of specific competences and to remedy this by seeking external expertise. Better companies react before a profit squeeze becomes a liquidity crisis, perhaps guided by wise counsel from non-executive or other senior advisers.

But for those managements in denial it is only a matter of time before failure to address operational issues becomes a financial issue and insolvency looms. Insolvency is value destructive. Assets are sold at depressed values, jobs are lost and the process is fee intensive. Secured creditors may make a full recovery but other creditors and shareholders do not. It is bad for UK Plc. too, as it adds to unemployment and state benefits. Insolvency should be a last resort, only used when all else fails.

AVOIDING INSOLVENCY

Having failed to respond adequately to changing conditions and with cash and available bank lines running out, management is at a crossroads. It is too late for operational change to be effective. The other normal remedies have failed; external investors are too wary to invest and happy to wait for the business to tip over, then buy in at a discount. That sale or merger never materialised. Financial engineering has put a sticking plaster over the income statement and balance sheet, but failed to generate cash. Trade creditors have been pushed to the limit. Banking covenants are broken and financial creditors are demanding solutions. Some large payments are looming, normally payroll or taxes, and there is insufficient forecast headroom.

Management have a decision to make and they need professional advice. Choosing the right advisers is critical. Their lawyers will be advising on directors' liabilities, and their accountants, who are often both financial advisers and insolvency practitioners, are conflicted when making that critical judgment of "to file or not to file". Banks and financial creditors may recommend an adviser but the debtor should want independence and someone who acts solely in its interest. This should be a turnaround and restructuring manager, one who is not an Insolvency Practitioner (IP) or part of an organisation that undertakes insolvency assignments. Whereas, until recently, banks would recommend advisers, a now largely discredited practice, care should be taken that the adviser focuses on debtor advisory rather than creditor advisory.

The choice should be a debtor advisory boutique or turnaround practitioner, preferably with a recognised qualification such as a Certified Turnaround Practitioner, acting as either restructuring adviser in a consulting capacity or as Chief Restructuring Officer (CRO), a temporary executive function which aligns its fiduciary duties with those of the directors.

If the CRO can identify a viable core business entity and some residual liquidity, he will seek, through his experience and judgment, to avoid insolvency and, through his experience and the credibility he brings, begin the process of operational change and negotiation with all stakeholders to stabilise the situation as a prelude to turning the ship around.

INTRODUCING THE CRO

Stepping into a crisis is not one to be taken lightly. Trust in management has broken down. The CRO must instil trust from the outset and must have knowledge of the complexities of the legal issues in the zone of insolvency; have experience in strategic, operational and people management; and a sound financial understanding.

Studies have shown that in most cases a CRO can operate with existing management, thus avoiding the cost of excessive external professional support. Whereas the CEO may have to be replaced or extensively coached, the incumbent management team usually respond to new leadership familiar with the pressures of distress. With the CRO focused on stakeholder negotiation, management can concentrate on the business priorities determined by the CRO; primarily cash flow and cost containment, but with an eye on customer and supplier relations.

First priority is to stabilise cash flow and to identify the core business to resuscitate. Once a recovery plan is determined it will identify the funding level that the new business can support. Armed with this, negotiations can begin to seek financial forbearance that may be debt reduction, debt deferment or debt to equity, but the outcome must be better than would be recovered in any form of insolvency process.

The range of solutions is broad and is dependent on the circumstances of the distressed company. The one constant is that, by avoiding insolvency, the value of the saved business is greater than the break-up value. Managing the negotiations and reconciling different stakeholder positions under financial and emotional pressure is a skill set that distinguishes the CRO from most financial advisers.

The ability to take executive responsibility, to change failed corporate strategies and instil cultural change sets the CRO role apart. A role and term that emanated from the USA at the beginning of the millennium, the concept of the CRO as a positive agent for change in distress is now firmly established in Europe.

CONSENSUAL RESTRUCTURING

Restructuring was, until recently, financially driven, with banks as secured creditors driving the process. As financiers, seeing things through a financial prism, they were most comfortable working with accountants who were often also IPs.

While the secured creditor exited without great loss, the process left value on the table to be picked up by opportunistic investors and the insolvency profession's fees at the expense of other stakeholders. Experience has shown that consensual restructuring saves value for all stakeholders. It is the most economically efficient solution to distress for the greater business community. With this economic advantage over insolvency it has become the process of choice for both debtors and creditors.

ABOUT THE AUTHOR

Alan Tilley is founding principal of Bryan Mansell & Tilley LLP (BM&T), a leading turnaround boutique. BM&T is a pioneer in the introduction of consensual restructuring in the UK and Europe. He has experience on more than 50 assignments ranging from family-owned SMEs to international public companies. He is co-author of the ICAEW Guide to Turnaround 2011, Insolvency and Rescue UK Turnaround Manager of the year 2010, and TMA Global International Turnaround winner 2011. He is a European Certified Turnaround Professional (EACTP), founding director of EACTP and Chairman of its Education and Training Committee.

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