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BEST-PRACTICE GUIDELINE

TURNAROUNDS

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Issue 53



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ISBN 978-0-85760-265-8

GUIDELINE

INTRODUCTION

EVOLUTION OF TURNAROUND PRACTICE

The legislation governing the protection of creditor and debtor interests in corporate distress is still evolving. It varies from jurisdiction to jurisdiction and this impacts on turnaround and restructuring practice in international cases; an increasing issue in a global economy.

Different legislation in different countries is also impacting the evolution of the turnaround process as professionals move from country to country and challenge accepted local practice. In the UK, the growth in US investment banks in London has led to the import of concepts rooted in the US bankruptcy process where it has been more appropriate to give failed entrepreneurial activity a second chance.

The 1979 US Bankruptcy Code facilitated the process known as 'debtor in possession'. Management was given the chance to reorganise the business and restructure the balance sheet under court supervision while managing day-to-day operations protected from creditors by an automatic stay. During the 1980s a new group of professionals emerged in the US, skilled in helping management to navigate through the complexities of managing in this 'zone of insolvency' (see Scope and definition of a turnaround). These became known as turnaround managers and the role of chief restructuring officer evolved later to describe this activity.

TURNAROUND MANAGERS AND CHIEF RESTRUCTURING OFFICERS

In the UK, change managers or 'company doctors' took over ailing businesses as chief executives and were statutory directors. But as companies slimmed down and flattened their management structure a need developed for executives with specific skill sets to work on an interim basis to drive change. This could be change by a specific project in a solvent company or, where it involved a major redirection of effort to prevent decline becoming corporate failure, change in the zone of insolvency (see page 5) to prevent an insolvency filing.

Following the Insolvency Act 1986 and the introduction of licensed insolvency practitioners it became convenient to distinguish professionals engaged in corporate rescue ahead of formal process from insolvency practitioners and the term 'turnaround manager' evolved. As turnaround management boutiques from the US established a presence in the UK the more formal title of chief restructuring officer (CRO) became prevalent. Banks would often make the appointment of a CRO a condition of a standstill agreement and while it has no statutory definition

the term became recognised as an important element of corporate rescue.

GOOD PRACTICE IN THE UK

Turnaround managers or CROs normally have a background in senior operational management with a corporate organisation, or financial services with a professional services organisation or bank, during which time they would have developed the experience to negotiate and manage stakeholder expectations under extreme financial pressure and to tight deadlines. Regular educational events and annual conferences are run by two membership organisations: Turnaround Management Association UK (TMA-UK) and the Institute for Turnaround (IFT), both of which promote high ethical standards and codes of practice.

DIRECTORSHIPS, SHADOW DIRECTORS AND RESPONSIBILITIES AND LIABILITIES

Neither the position of turnaround manager nor CRO has precise legal definition in the UK. Accordingly the terms of engagement and duties must be defined in an engagement letter which should be clear on scope and reporting responsibility. Whenever possible this should be a direct report to the chairman or board of directors to ensure the turnaround manager has the requisite authority.

The position is not consultancy or advisory. It is by necessity hands on and, therefore, is an executive role. It is not necessary to be a statutory director to perform the function and is best avoided so as to exhibit a degree of independence to external stakeholders and a disassociation with directors' past actions. However, it is likely that acting in an executive and leadership capacity will be interpreted as acting as a shadow director and subject to the same duties, responsibilities and potential liabilities as a statutory director. A shadow director is a person in accordance with whose directions or instructions the directors of a company are accustomed to act. A person is not deemed to be a shadow director if it is clear that he is acting in a professional advisory capacity only.

A turnaround manager or CRO should conduct himself within the statutory duties of a director and as if he was a director, while maintaining a position of independence and objectivity to all stakeholders.

As a company enters the zone of insolvency the directors' responsibilities move from protecting shareholders' interests to a duty to protect the interests of creditors. In a potential liquidation if turnaround efforts fail, a director or shadow director may be held personally liable for civil damages for wrongful or fraudulent trading, or criminal damages for fraud misconduct or falsification of accounts. A turnaround manager working in the zone of

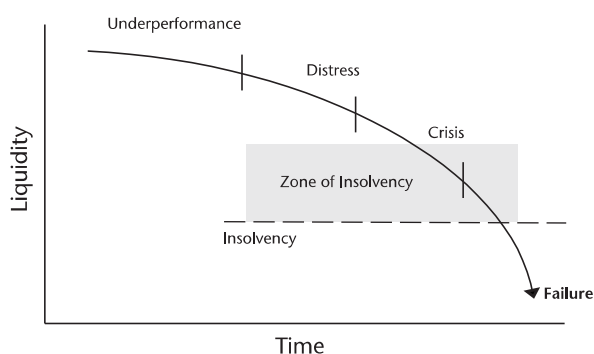
insolvency must acquaint himself thoroughly with the legal implications of his actions and ensure that his decisions are both properly documented and capable of defence. He should act with integrity and transparency at all times. He should ensure his actions maintain enterprise value and do not damage the interests of all or any one group of creditors. In this way he should avoid the potential risks of subsequent legal action. In any event acting with integrity and transparency with all stakeholders will enhance rather than undermine the chance of a successful outcome. It is not just an ethical approach to turnaround but the most practical one.

SCOPE AND DEFINITION OF A TURNAROUND

POINT ON THE DECLINE CURVE AND THE ZONE OF INSOLVENCY

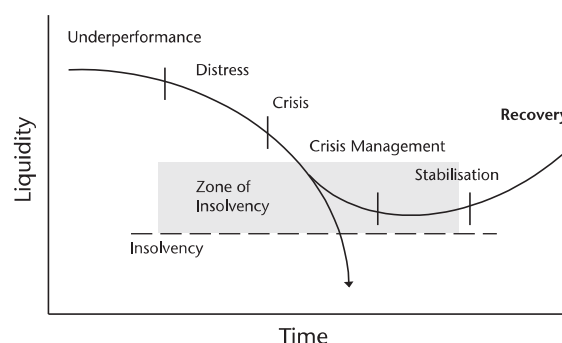
Companies are dynamic. They are either moving forward or backwards against competition. When moving backwards management has the opportunity to change policies to reverse the trend. When management fails to address the issues and falls into a state of denial they embark on the decline curve (see figures 1 and 2). They may institute a change of direction from internal action while they have the liquidity to manage the necessary changes to management and policy. Or they may continue down the decline curve until their financial position makes them vulnerable to an external shock such as loss of a major customer or contract. At such time they are likely to be in the zone of insolvency and under liquidity pressure. Turnaround management actions discussed in this guideline relate to turnaround management at this point of decline. As this will be a point of extreme creditor pressure, turnaround with consensual creditor

Figure 1: The Decline Curve



support and turnaround by leveraging concessions under threat or other near insolvency-related processes become intertwined and these issues are considered below.

Figure 2: The Turnaround



WARNING SIGNS

In an entrepreneurial society there will always be business failures. What is essential is a mechanism to rehabilitate failing companies to preserve as much value as possible. As live companies are inherently worth more than dead companies early recognition of failure means earlier turnaround action and increased chances of success. However, management can be the last to recognise the symptoms, or action the remedies, and remain in denial until it is too late. Recognising the symptoms from outside is less easy to achieve but nonetheless there are telltale signs.

There are two basic approaches to evaluating risk of business failure: the statistical approach and the intuitive approach. The former depends on the availability of accurate and timely data and uses statistical analysis of liquidity, profitability and gearing to evaluate the likelihood of an insolvency event against a benchmark of historic data. It is more relevant to larger publicly traded companies with complex capital structures where information is in the public domain than small- to medium-sized companies.

The intuitive approach is more familiar to readers of financial statements and observers of business and management. While based on the same factors as the statistical approach it relies on reader judgement over statistical evidence. The financial symptoms are those of declining profitability, declining sales and margins all of which lead to liquidity pressure, inventory build-up and collection and aging problems on receivables. As the process continues the company begins to miss forecasts, both profit and cash. Funding headroom diminishes and covenants come under threat. Supplier payments get extended leading to production scheduling problems.

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At this stage the company is in the vicious circle of decline with efficiencies, quality and service levels declining and customers defecting.

This becomes a key defining moment; if new management changes are made which can arrest the decline the company may navigate its way to safety. If management remains in denial a liquidity crisis becomes almost inevitable. However, it is often preceded by desperate measures to hide or sidestep the problem. In the final stage of decline financial statement irregularities or failed merger or disposal attempts are not uncommon. While senior management, preferably chief executive, change is needed the better internal managers desert the sinking ship. Unfortunately only when external pressure is brought to bear is it likely that a turnaround manager is appointed. Often this only occurs when the company's bank relationships are transferred from the normal relationship managers to a work-out department. Work-out departments are comprised of experts in distressed situations and it is their role to maximise the bank's recovery from a distressed business. It is regrettable that turnaround managers are appointed later than they would like to be. Thus the norm on appointment is entering a liquidity crisis.

LIQUIDITY TRIGGERS

Companies do not fail through lack of profits. They fail through lack of cash. A company should consider filing for insolvency if it is unable to pay its debts as they fall due in the normal course of business. In practice there is often a degree of latitude to this definition and businesses have been known to limp along, living from hand to mouth until a critical payment cannot be met which makes continued trading impossible. Such an event could be insufficient funds to meet payroll, insufficient funds to secure delivery of a critical component or the interruption of utilities. It may also be triggered by a creditor petitioning for a winding-up order or a bank withdrawing facilities for breach of covenant. For a turnaround manager, having visibility and effective control of the cash flow is the critical first stage in any assignment.

BASIC REQUIREMENTS FOR A SUCCESSFUL TURNAROUND OF A DISTRESSED BUSINESS

Not all distressed businesses can or should be saved. From the outset the turnaround manager must make the decision whether turnaround or break up in formal process is appropriate.

SHORT-TERM LIQUIDITY

A turnaround manager cannot produce cash from thin air but he can make a reasoned assessment of the immediate cash requirement and availability. Depending on the size of the company and the complexity of the business it may take one week to one month to determine a plan of action and a dependable cash flow forecast to support it. The first step is to rigorously analyse the cash control and to impose a strict discipline over collections, payments and purchase ordering, if necessary taking over direct management of these functions. Surprisingly, distressed companies can have cash management delegated at too low a level, with non-urgent payments continuing due to lack of supervision. Establishing proper priorities over payments can conserve scarce cash resources buying time for longer-term solutions to be sought.

VIABLE CORE BUSINESS

Having assessed the ability to survive at least while a survival and recovery plan is prepared, an assessment of business viability should be made. Is there value in the goodwill of the business over and above the realisable value of the assets? This is considered in more detail below but mindful of the possibility of wrongful trading a turnaround manager must assess whether the business has the products or services that meet a market demand and can support a valid revenue stream to produce an operating surplus. If not then administration or liquidation may be the appropriate route.

CREDIBLE MANAGEMENT TEAM

From the outset of appointment of a turnaround manager the incumbent management team will be associated with the business problems. Often they will have lost supplier confidence by breaking payment commitments, and customer confidence through quality or delivery issues. The turnaround manager must bridge the credibility gap at the outset. Whom to make redundant, when and how is a matter of judgement. Turnaround is a team effort and management have the product knowledge and customer contacts that are essential for business success. This knowledge must be retained. Harnessing and controlling those attributes while demonstrating leadership in the turnaround to all stakeholders is required.

The turnaround process will take time and the rebuilding of the management team will also take time. Directors may be shareholders with controlling positions or have service contracts with expensive termination clauses that cannot be met from cash flow. As the turnaround process progresses the turnaround manager must win the confidence of those members of the management team required for the future business while retaining credibility

with external stakeholders whose support will be needed to achieve success. Those members of the management team discredited beyond redemption or otherwise surplus to requirements must be removed as and when liquidity permits.

FUNDABLE BUSINESS PLAN

Having established business viability, sufficient liquidity to prepare a survival and recovery plan, and established management control over the operations the emphasis moves to the preparation of a business plan that is both credible and fundable; credible in that the revenues and margins are based on a realistic assessment of the state of the overall market and of the business's competitive position, and fundable in that the level of debt of the ongoing business can be serviced by realistic operating profits and cash flows.

In tandem with the preparation of the plan the turnaround manager must continue to ensure control over the operations and finances of the business and to consider the tactical approach to stakeholder negotiations. Concessions and support will often be required and the turnaround manager must assess the strength of his leverage before beginning negotiations.

MANAGING THE IMMEDIATE LIQUIDITY CRISIS

ESTABLISHING IMMEDIATE CONTROL OVER TREASURY MANAGEMENT

Almost the first step a turnaround manager must take is to establish the exact liquidity position of the business. This will require immediate access to bank statements and internal cash flow forecasts. There will be pressure from creditors (many already overdue) as well as pressure to meet key payments: payroll, utilities and rent. From the start it is imperative that executive control is assumed over cash management. On large assignments this may be done by parachuting in a dedicated cash manager. In other assignments, where there is a capable accounting function, control can be achieved by delegation and tight daily management. Whatever the solution, in the first days of an assignment, visible and effective control of cash availability by the turnaround manager is essential if an insolvency trigger is to be avoided. As soon as practical after averting an immediate crisis a more formal process of cash flow forecasting and management must be implemented.

PRIORITISING KEY PAYMENTS

Payment pressure will come from those creditors with the tightest credit control functions, the most aggressive

collection procedures and the most leverage. Threats to take legal action will occur. However, the use of scarce liquidity to meet the most aggressive collectors may not be the optimum use of funds. First call on cash must be payroll and as this is usually the biggest single obligation and occurs only at the end of the month this must be factored into cash flow as the number one priority and with a built-in safety margin. A business cannot run without power or telephones so these must also be given priority. A check must be made to ensure that any court orders and legal threats are handled. If a court judgment has not been made the creditor should be contacted and an understanding of revised payment terms reached. Depending on the critical nature of the vendor this could be a deferred payment plan progressively reducing the total outstanding but tied to a continuation of supply.

A turnaround manager brings credibility to the process but must be frank and accurate. Payment promises and plans must be achievable and achieved to preserve credibility. As confidence is restored the immediate pressure eases. However, confidence restored can be quickly lost if payment plans are missed or communication is lost. It is better to communicate bad news changes to plan than not to communicate.

IDENTIFYING 'LOW HANGING FRUIT'

In many companies cash collection is delegated at too low a management level and regarded as a chore or an embarrassment by senior management. It is commonplace for companies in the zone of insolvency to have significant overdue debtors. Payment delays may be due to warranty issues, contract completion issues, settlement disputes or just customer payment delays. Intense senior management attention needs to be focused on resolving disputes and issues to collect in all outstanding debts and then keeping on top of cash collection.

EXAMPLE 1

At an auto parts supplier in Germany and Portugal an outstanding debt of over €500,000 from a major manufacturer in Mexico was one year overdue because of confusion over VAT applicability on shipments from Portugal to Mexico. By research and determined follow up with the various tax authorities in both countries the matter was agreed to the customer's satisfaction and the cash received. This was one of a number of overdue accounts which together were making the difference between solvency and an insolvency filing.

Invoices should be promptly raised and sent to expedite due dates.

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EXAMPLE 2

Invoicing of large contracts was handled by a remote department ignorant of liquidity pressures at head office. Invoices would take many days to raise and despatch. By expediting the process, over 30 days of cash flow benefit was achieved.

Excess inventories can be sold off even at a discount if this improves liquidity. Work in process may have accumulated due to production parts shortages.

EXAMPLE 3

At a major international capital goods manufacturer more than a month's production of machines worth over €3m was held awaiting critical parts from overdue vendors thus creating a vicious circle of adverse cash flow. By cutting production schedules and diverting resulting cash savings to finish and dispatch the held units, positive cash flow was restored and production rebalanced within available cash resources. In time, production levels were increased as cash availability permitted and profitability restored.

Likewise other surplus assets may exist that can be turned into cash. This can be scrap inventory, excess motor vehicles, surplus plant and equipment, non-critical subsidiaries or branch operations, or surplus real estate. It may be necessary to take less than book value to generate much needed cash but this may be a loss worth taking to save the company.

EXAMPLE 4

At the same international manufacturer it was necessary to dispose of the French and Spanish subsidiaries to generate much needed cash to enable the US parent to continue operations while its own disposal to a Korean investor was negotiated.

CONTROLLING SUBSIDIARIES' CASH MANAGEMENT

Groups that do not have centralised treasury management require specific attention as cash records and access to bank accounts may be delegated to the subsidiary. There is a risk that a liquidity event could happen unbeknown to the parent company. More common is the hiding of cash availability at the subsidiary level and the inefficient use of cash to pay suppliers on due date ahead of greater priorities elsewhere in the group. Direct control over subsidiary cash management should be instituted immediately.

Subsidiaries may also have undisclosed funding headroom.

EXAMPLE 5

On an international assignment for a US company in breach of covenant and under bank work-out department supervision, it was noted that the French subsidiary with an intercompany liability of over US\$5m had unused factoring facilities of US\$3m. By using the facility to the maximum much needed cash was up-streamed to the parent.

ASSESSING BUSINESS VIABILITY AND ENTERPRISE VALUE

Having addressed the capabilities and competencies of the management team and getting a sense of the cash available, the turnaround manager must consider whether the business or parts of it have viability. The risk of further erosion of creditors' value and of the directors' fiduciary duties to both secured and unsecured creditors of the business should also be evaluated.

An initial view has to be taken: whether the strategy is to return the business to generating average earnings in the medium term or whether the focus should be an exit through a sale where specific cash and earnings strategies will be applied to enhance the sale value.

LIQUIDATION ANALYSIS AND BREAK-UP VALUE

The turnaround manager will need to prepare an analysis of the company's business and assets. An estimate of the outcome for each class of creditor on both a going concern basis and a break-up basis is required to inform his discussions with management of stakeholder groups.

Initially an assessment of the company's latest balance sheet, management accounts and asset registers must be undertaken and it should be established whether the company's records are up to date. Where specialist assets exist it is recommended an expert valuation agent is instructed to report on the value of the company's business and assets on a going concern and break-up basis. The valuation analysis will distinguish between the assets that are owned and encumbered and provide a considered estimate of the value of intangible assets such as goodwill, intellectual property and trademarks.

The turnaround manager will also need to determine the liabilities of the company, ensuring that all secured, unsecured, contingent and prospective claims are identified. This will require the assistance of management as it will be necessary to determine liabilities owing under employee contracts including pensions, landlord claims,

hire purchase and rental or contract hires, as well as normal trade creditors.

Once armed with the values of the assets and liabilities of the company, the turnaround manager will prepare an estimated outcome statement showing the likely outcome for all classes of creditors and will help him determine whether there is any potential value in the goodwill of the business, whether it can be preserved, and therefore whether a turnaround approach is appropriate.

VALUE BREAK FOR SECURED AND UNSECURED LENDERS

In a restructuring in insolvency, the value that will be returned to creditors after the costs of the restructuring process will be distributed in accordance with the statutory order of priority. Broadly, secured creditors receive the first distribution, and then unsecured creditors.

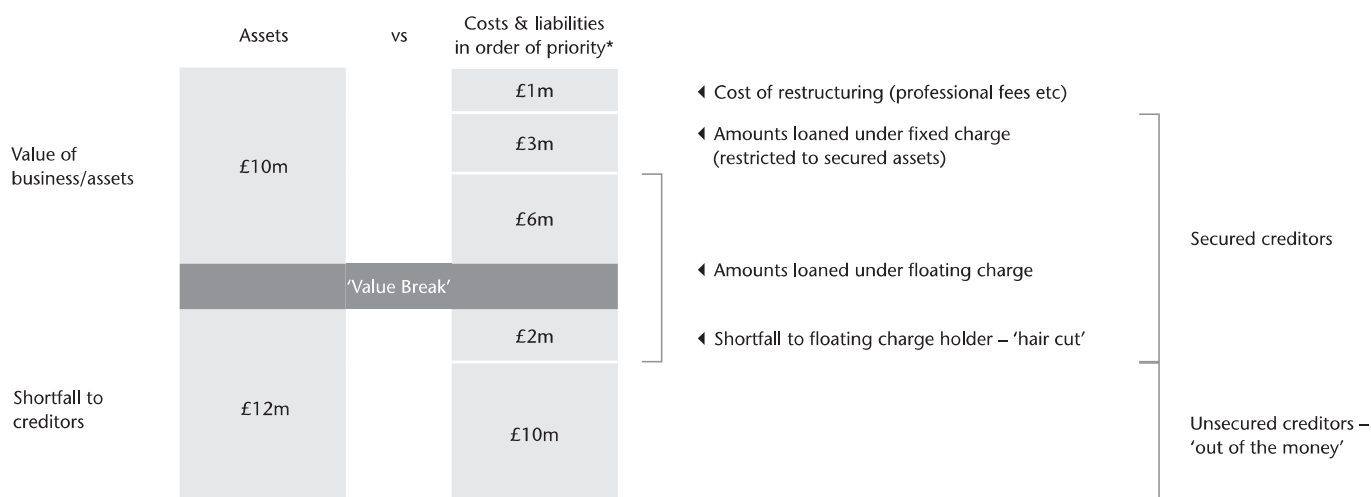
The return that each class of creditor receives will be dependent upon the value of the business and/or its assets – and how far this can be allocated to creditors in their order of priority. The point where the cash runs out is known as the ‘value break’ (see figure 3). Those creditor groups that are underwater ie, where the security that they hold, if any, entitles them to receive little or no value for their existing exposure, are unlikely to support an insolvency-based restructuring of the business. In all cases, therefore, the creditors with highest ranking security will need to be supportive of any restructuring proposals that the turnaround manager puts forward and be comfortable that there are no significant risks to their position.

SUBSIDIARIES AND NON-CORE OPERATIONS

Businesses are structured in many ways with situations varying from a single to a multitude of statutory entities owning the various parts of the business. These sometimes, but not always, fall into discrete operating business units. In approaching the turnaround situation, the turnaround manager will need a knowledge of what commercial processes are undertaken within each entity, and how integrated these functions are, or have to be, for the group. Shutting down a loss-making entity whose continued operation is essential to the wider operations and future profitability of the rest of the group should clearly be avoided!

In simpler group structures there may, however, be quick wins that the turnaround manager can achieve. Underperforming, non-essential divisions that are held in discrete statutory entities but are a drain on the remainder of the group are obvious candidates to be placed into an insolvency process such as liquidation, allowing the turnaround manager to focus on the rest of the business which can be saved. Again, existing management is important in obtaining the detailed knowledge required to make these assessments but so are the company’s legal advisers who will be able to advise on which entities hold title to specific essential assets and which entities hold the lucrative contracts that are to be continued by the business once it has been turned around.

Figure 3: The Value Break



GUIDELINE

DEFINING THE OPTIMUM CORE BUSINESS

In many turnaround situations the solution adopted will involve the restructured business focusing on its market sectors and customers where profitability can quickly be achieved. Forming a view on this will also drive the structural mechanics of how the business is to be restructured and the changes to the underlying entities within the group that need to occur.

REASSESSING THE VALUE BREAK AND SELECTING THE OPTIMUM PROCESS

Having decided upon the viability of the industry and the company's potential position within it once turned around, a reassessment of the value break and whether this can be enhanced for creditors or shareholders should be undertaken. If the costs of the restructuring detract from the value that can be gained through an insolvency process then that route should be taken. However, if a restructuring can be economically undertaken that will enhance value and push the value break lower down the order of priority so that more creditors are 'in the money', this route should be followed.

More than one possible way of restructuring the business to achieve the turnaround will exist and, depending upon the particular circumstances of the company or companies involved, all possible methods should be explored and evaluated by the turnaround manager so that he can bring into effect his turnaround plan.

CONSENSUAL RESTRUCTURING

Where a broad consensus exists, or can be created, a consensual approach to a restructuring is often preferable to a formal insolvency-related approach which usually impairs the value of goodwill. A consensual restructuring avoids the costs and stigma of an insolvency process and the resultant detrimental impact on the business which the turnaround manager is attempting to save. Entering a formal insolvency process can typically lead to adverse press coverage which may in turn drive a change in customers' attitudes, and also causes uncertainty for staff, whose retention and performance may be critical to the success and survival of the business.

CVAs, SCHEMES OF ARRANGEMENT AND PRE-PACKS

In assessing business viability and an optimum solution, the possibility of using these processes should be part of the evaluation process (see Negotiating the financial restructuring).

Company Voluntary Arrangements (CVAs) can be used by a near insolvent company to help reduce and

reschedule payments to its creditors without entering formal insolvency. A CVA takes place between the company and its creditors and can be tailored to suit specific circumstances ie, in order to effect compromises and settlements with a particular creditor or class of creditors. Typically the terms of CVAs can last for three to five years.

A scheme of arrangement (Scheme) is a compromise or arrangement between the company and its creditors (or any class of them) and/or its shareholders (or any class of them). A Scheme is similar to a CVA; however, it is not an insolvency process under the Insolvency Act 1986 as it is proposed by the company under the Companies Act 2006 and requires court sanction.

A pre-pack is a situation where a deal for the sale of a company's business and/or assets is negotiated before insolvency and the sale is completed immediately following an insolvency appointment. Pre-packs often involve the sale of the business back to the existing owners or management. This route is commonly used where the owners and directors of a business are closely associated with it and where a speedy transaction is needed to keep continuity of service to customers and suppliers. Pre-packs can be contentious and liable to challenge if the objective is to avoid creditor liability by undervaluation of the assets transferred to the new venture. Accordingly care and objectivity, preferably by third parties, should be taken over business and asset valuations. Pre-packs are not appropriate where greater value would be achievable for the creditors in a normal administration.

MANAGING THE BUSINESS OPERATIONS DURING THE TURNAROUND PROCESS

THE ROLE OF MANAGEMENT AND EMPLOYEES

Managing a turnaround is a team effort. A turnaround manager brings focus, priorities, experience, credibility, leadership and energy to the process. He takes the leadership role in managing stakeholder expectations. The management team continues to manage the day-to-day business and manage the employees. However, with the poor performance occurring on their watch, there may have been functional discord in the team. Identifying that dysfunction and remedying it is a priority. This may be simply by changing emphasis in priorities or having to remove a disruptive influence.

A criticism sometimes levelled at turnarounds as opposed to the more abrupt removal of management teams that occurs in most insolvency processes is that the management team which caused the problem still remains.

In reality in a turnaround the management structure and team on the departure of the CRO is not the same as the team on his arrival. The change is evolutionary rather than revolutionary so that the CRO can preserve the best and release the non-performers progressively while retaining essential skills and business knowledge.

CASH FLOW AND TREASURY MANAGEMENT – 13 WEEK CASH FLOWS

Gaining control of cash flow and treasury management is the immediate priority for survival. Continuous management of it thereafter is critical. The 13 week

cash flow is an essential tool in this process and should be managed at a senior level, monitored by the CRO and be understood by everyone in the management team who has an influence on maximising receipts and collections and committing expenditure and payments.

Table 1 shows a basic receipts and payment format. Each line should be supported by an appropriate level of detail and delegated accountability. The report should be updated weekly and discussed at the beginning of each week at senior level under the CRO's direction. Renewed priorities should be established. The past week's actual performance should be analysed and investigated.

Table 1:
13 Week Cashflow Forecast

	Date xxxxx (Week 26)			FORECAST						13 Week
	Week 25									
	Actual	Fcast	Var +/(-)	26	27	35	36	37	38	TOTAL
SALES (£000s) (Note 1)										
Customer / Product / Channel A (Note 2)	3,859	4,483	(624)	4,762	4,573	4,376	4,167	4,596	4,773	54,643
Customer / Product / Channel B	1,979	2,167	(188)	2,269	2,230	2,094	2,068	2,036	2,096	26,425
Etc – analysis compacted for simplicity	8,771	8,388	383	9,616	9,368	7,605	7,768	7,644	7,621	106,920
TOTAL SALES	14,610	15,038	(428)	16,647	16,171	14,075	14,004	14,275	14,490	187,988
INFLOW (£000)										
Customer / Product / Channel A (Note 2)	6,097	4,864	1,233	2,537	6,401	1,988	3,594	4,454	8,159	62,613
Customer / Product / Channel B	1,832	592	1,240	900	568	361	364	3,130	6,675	37,270
Etc – analysis compacted for simplicity	13,644	19,413	(5,768)	10,171	3,115	733	4,664	10,553	26,515	153,874
TOTAL INFLOW	21,573	24,869	(3,296)	13,608	10,084	3,082	8,622	18,137	41,350	253,757
OUTFLOW (£000)										
Suppliers	29,230	29,275	(45)	12,743	4,840	10,676	5,085	4,762	23,711	146,518
Utilities	765	1,147	(381)	379	270	330	323	412	355	4,888
Payroll	1,775	2,669	(895)	1,824	1,932	2,840	56	391	9,923	47,142
Capex	648	1,306	(658)	134	1,303	2,074	173	163	223	9,005
Closure / Relocation expenses (excl payroll)	215	262	(47)	1,799	203	2,680	38	0	0	13,484
VAT & Sales taxes	535	568	(34)	558	524	980	392	361	697	6,939
Corporate taxes	61	47	14	970	697	2	53	112	2	3,953
Debt service	0	0	0	0	0	0	0	0	0	0
Lease payments	596	436	160	87	274	113	146	98	111	1,567
Interest	19	83	(64)	0	0	0	3	0	19	71
Etc – analysis compacted for simplicity	2,004	1,825	179	2,126	1,921	2,386	2,151	2,668	3,267	35,948
TOTAL OUTFLOW	35,847	37,618	(1,771)	20,620	11,964	22,081	8,419	8,967	38,308	269,513
NET INFLOW / (OUTFLOW)	(14,274)	(12,749)	(1,525)	(7,012)	(1,880)	(18,999)	204	9,170	3,042	(15,757)
			Forecast accuracy:							
			89.3%							
Opening Balance	(13,500)	(13,500)	0	(27,774)	(34,786)	(36,947)	(55,946)	(55,743)	(46,573)	(27,774)
Closing Balance	(27,774)	(26,249)	(1,525)	(34,786)	(36,666)	(55,946)	(55,743)	(46,573)	(43,531)	(43,531)
Facility	(50,000)	(50,000)	0	(50,000)	(50,000)	(50,000)	(50,000)	(50,000)	(50,000)	(50,000)
Headroom + / (-)	22,226	23,751	(1,525)	15,214	13,334	(5,946)	(5,743)	3,427	6,469	6,469
						(Note 3)	(Note 3)			

Notes:

1. Sales forecasts are included as a reality check to ensure that cash inflows are not out of line with sales over time.
2. Analysis should be appropriate to the business and its cash flows. This may be by customer, by product, by distribution channel etc. Sales receipts from factoring should be identified separately.
3. The forecast shows that cash will remain within facilities for the 13 weeks as a whole but action to delay payments or accelerate receipts will need to be taken in weeks 35 & 36.

GUIDELINE

Too often this is neglected and shortfalls are rolled forward into the future. Moving the goalposts is weak and ineffective management. Percentage accuracy of weekly performance should be measured and underlying causes investigated and remedied. Anything less than consistent 95% accuracy levels will cause too high a level of unpredictability and risk tripping an insolvency trigger.

FINANCIAL AND NON-FINANCIAL PERFORMANCE INDICATOR REPORTING

Once control is established over cash the CRO will concentrate on ensuring that timely and accurate reports of all essential financial and operating performance data are received. The survival of the business will depend on continued order intake and improved operational efficiencies. The critical quality of the cash flow reporting will depend on the accuracy of sales forecasts and production forecasts. Working capital levels will depend on the accuracy of production schedules and resource allocation. Key information should be available on a frequent and regular basis. The CRO should be aware of the factors affecting the normal rhythm of the business. In this way activity and actions can be prioritised. In the short-term survival and achievement of a stable platform results from immediate knowledge of where the leaks are so they can be attended to first. Without stability and confidence in the forecasts a CRO cannot command the necessary credibility to engage effectively with stakeholders and negotiate with any certainty of deliverability.

PERFORMANCE ENHANCEMENT – COST REDUCTION

Turnaround is not just about cutting costs and restructuring balance sheet debt. However, cost reduction is the most practical way to improve the bottom line in the short term. In most companies the largest costs are employee costs but redundancy programmes are cash intensive and disruptive. Nevertheless, they are usually the easiest way to cost reduction as control is in the hands of management. They should be implemented as soon as cash availability allows and should be done with due regard to contractual and legal requirements. Subject to obligations to adhere to consultation periods the process should be as quick and clean as possible to remove uncertainty for those not affected, allowing the remaining employees to put the upheaval of redundancy behind them and concentrate on the future.

It may be possible to reduce costs by engaging with employee representatives and negotiating short-term working arrangements and wage reductions. This is an option when there is reason to believe that activity level reductions are temporary and will increase.

In the 2008/9 downturn many UK firms achieved such

EXAMPLE 6

On an assignment in Germany a 10% wage reduction was achieved as part of a broader recovery plan with the essential cooperation of union representatives.

concessions with benefit to the employees in job retention and the company in retaining essential skills while conserving cash.

Other overheads that should be cut or deferred while the turnaround is progressed are those not required for immediate benefit to revenue generation such as advertising and marketing, business rates on surplus properties, property maintenance, and non-essential travel. However, such measures come with their own dangers attached and while a CRO needs to make difficult decisions a degree of judgement is required not to do irreparable damage to the business.

In manufacturing businesses materials often represent a significant cost. Reducing material cost is a more long-term process but cost reduction task groups should be put into action. Areas to be considered are supplier change, material substitution, design change and process change. Additionally a CRO should consider dropping low margin products from a range to reduce unprofitable activity. Care should be taken to ensure that decisions are taken on the variable cost basis and not the fully absorbed cost basis which will just leave fixed overheads to be recovered on other product lines.

PERFORMANCE ENHANCEMENT – MARKETING AND TOP LINE MANAGEMENT

While it is not unknown to plan or effect a turnaround by increasing prices or sales volumes it is normally unrealistic to plan a turnaround on short-term revenue increases. But the top line performance needs as much attention as the cost base. Preserving present revenue levels is essential to cash generation and a return to profitability. In the longer-term having a credible marketing plan that supports business growth is important in attracting new funders. Again, ensure the plan is based on credible market data and achievable market shares. The 'hockey stick' revenue forecast, where revenues grow slowly at first and then shoot up, is difficult to sell to doubting stakeholders and potential funders.

The CRO will quickly initiate or undertake a competitive analysis of the company's product lines and where possible seek selective price increases. External resistance is to be expected. Internal resistance should be tested by factual evidence. Sales departments can be reluctant to raise prices but, if the evidence supports a price rise, resistance can be tempered by incentivising incremental sales and margins.

Companies have more leverage over their customers than they may appreciate. Resourcing supply from any supplier can be unwelcome and costly for a customer as supplier qualification processes may be time consuming and bureaucratic. So while it is important to maintain quality and delivery performance a customer may be open to reasonable pricing support if properly approached. Just in time supply (JIT) and single sourcing are not uncommon in business and a company may be an important supply chain partner. A customer may also want to keep competitive tension in the supply chain so will not willingly see a valued supplier fail.

The auto industry is a prime example of JIT practice. Auto assemblers do not want to see supply chain disruption as non-availability of a £100 part could close a £10m per day production line. The company may have critical dies and moulds, removal of which could be problematic. In the aerospace industry supply chain companies are closely monitored for quality and traceability. Supplier change is not an overnight decision. In such cases scope exists for price movement and should be carefully negotiated so that long-term relationships are not damaged.

SUPPORTING MANAGEMENT IN COMMUNICATIONS AND STAKEHOLDER MANAGEMENT

EMPLOYEES AND EMPLOYEE REPRESENTATIVES

Controlling the content of external communication starts with controlling communication internally. Once a CRO or turnaround manager is appointed employees will be contacted by customers, suppliers and service providers assessing their risk and exposure. Ensuring the right message gets back is important. From the outset a clear message should be communicated internally and advice on how to field calls should be given. The message should be objective and factual. Employees should be made aware that inaccurate gossip or alarmist talk can be detrimental to the recovery process and could fall into the wrong hands, particularly competitors seeking advantage. Wherever possible, internal communication should be face to face and filtered down the organisation through the normal line management route. Line management should be informed ahead of union representatives to demonstrate that management are in control of the process and to avoid misleading interpretations. The core message should be: 'We have issues that have been identified, are manageable and are being managed. With your continued support we will resolve them'.

MAJOR CREDITORS AND CREDIT INSURERS

Early communication to all creditors should be made as quickly as practical, especially to individual major and critical suppliers. No news is bad news in the early days of a CRO appointment. Maintaining supplier confidence, credit lines and supply chain performance is essential. Where a supplier has credit insurance the insurer should be included in the dialogue. It is the insurer and not the supplier who has the vested debt risk interest in avoiding insolvency.

Suppliers want the turnaround to succeed in order to get paid and retain a customer. They also want to minimise their risk by not increasing exposure and where possible reducing it. Pressure for early repayment of overdue amounts should be resisted without the quid pro quo of continued supply on normal terms while reducing the overdue level to normal terms over time and as funds permit.

Communicating the message that threats of legal action and supplier holds may force an unnecessary insolvency event should be carefully handled. Normally when a CRO is appointed there is already a history of missed promises. Reasonable payment plans should be negotiated. Payment plans should be achievable but equally they must be adhered to.

In order to concentrate on the major creditors it is sound policy to keep smaller creditors up to date. The 80/20 rule often applies to the creditors' ledger structure. The 80% of small creditors making up 20% of the liabilities are time consuming to manage and more likely to seek court action. It is better to concentrate time and resource on the critical larger suppliers than dissipate efforts in controlling the smaller suppliers with less vested interest in the company's survival and less experience of recovery from distressed situations.

As the trade creditor payment situation improves and there is a positive story to tell it will be time to address the whole supplier base with more accurate information of progress. A professionally staged supplier presentation event is a practical way of demonstrating progress and restoring the whole supplier base to normal credit terms. However, this should not be undertaken while certain suppliers remain hostile. Negotiations with less supportive suppliers should be on a one-to-one basis.

KEY CUSTOMERS

It is very easy in the early stages of a turnaround to be diverted from customer support by pressing crises on the cash and supplier fronts. However, a turnaround cannot be achieved without customers and early communication can hold customer loyalty while a clearer picture emerges. As the turnaround progresses, customer confidence translates

GUIDELINE

into reliable sales forecasts which become the basis on which a credible business plan can be built. A CRO needs to engage with customers to understand the market drivers of the plan upon which he will restructure the business and negotiate with funders.

Customers may also be contributors to the problem by deferring payment. Overdue accounts should be aggressively chased to improve liquidity. Opportunities for customer support by early payment discount or fast pay programmes should also be sought. This is not uncommon in industries where supply chain disruption could result in costly line shut downs and lost production.

EXAMPLE 7

On a major international auto parts supplier assignment the US parent was demanding loan repayments from its European subsidiaries to meet short-term US needs, which would have forced the European subsidiaries into administration. By approaching two major US auto manufacturers a fast pay programme was initiated for the parent that enabled the European subsidiaries to be restructured outside of formal process. The US auto manufacturers benefited as their European factories would have been at risk if the supplier's European subsidiaries had filed for insolvency.

LANDLORDS

Landlords are key stakeholders, particularly in the retail sector. English law lease agreements are heavily biased in the lessor's favour with onerous termination clauses and upwards-only rent reviews. In turnarounds with a large leasehold estate, exiting from onerous lease obligations has historically met strong resistance from landlords. As rental payments are traditionally quarterly in advance they have a significant adverse cash flow effect and landlords may be quick to seek court redress for late payments. Relief from leasehold contracts on properties surplus to requirements will depend on negotiating leverage. Early communication should begin to avoid provoking a court payment order and to seek a possible reduction in rent, a new lessee, or to sublet the property. Where onerous leases are a major issue and landlords are reluctant to seek commercial compromise the threat of, or use of, a pre-pack or formal administration may lead to a more balanced commercial compromise.

PENSION TRUSTEES

Many companies have closed their defined benefit pension schemes in favour of defined contribution schemes where the liability for future pensions is passed to the insurer. However, there may be residual pension liabilities under closed defined benefit schemes or a section, usually for

senior executives, may still be a defined benefit scheme. Pension liabilities are subject to regular actuarial valuations and shortfalls are generally the unsecured liability of the company. Trustees have certain rights and obligations to seek contributions to redress shortfalls arising from valuations which may also be provoked by a sale or closure of all or part of a company. These contributions may have a significant effect on cash flow and future profitability. In some cases resort to administration or pre-pack may be required for all of the business or perhaps an affected subsidiary. Early appreciation of the pension obligations is necessary and, being a complex area and subject to evolving legislation and practice, specialist advice should be taken.

DIRECTORS AND DIRECTORS' LIABILITIES

Directors have statutory obligations and potential liabilities when a company is nearing or in the zone of insolvency. To be effective a CRO, who is likely to be a de facto or shadow director, must maintain the confidence and support of all the directors. From the outset the CRO should ensure that the directors are fully appraised by appropriate legal counsel of their responsibilities and duties. In order to protect his personal interests the CRO should monitor the directors' actions and ensure significant decisions are properly discussed at board level and properly recorded in the minutes. Regular communication with the directors is needed to ensure the appropriate level of corporate governance is adhered to.

SHAREHOLDERS

While shareholders in a distressed company often have less financial leverage than secured debt and less commercial leverage than trade creditors they do have statutory rights that effect changes in the composition of the board and the capital structure. If a company is a public company these are also governed by stock exchange rules.

EXAMPLE 8

In a turnaround and restructuring of a significant publicly quoted company involving a debt to equity swap and new capital increase, the notice periods for extraordinary meetings to authorise shareholder dilution imposed time constraints that affected operational and cash flow issues. Minority shareholder groups were hostile to the proposed dilution and attempted to frustrate the process to improve their terms. The delays increased liquidity pressure and threatened to derail the turnaround plan. The CRO commissioned an independent fairness report to determine a reasonable valuation of the share price for the proposed capital change and led the subsequent discussions that resulted in shareholder acceptance.

Changes in capital structures will require shareholder approval and meetings called with proper notice. This can dictate both the form and pace of the turnaround. They also have powers of appointment of directors and their interests cannot be ignored.

In private companies the directors and shareholders are often the same people. They may have a conflict of interest in protecting their financial interests as shareholders and performing their duties to other stakeholders as directors. A CRO needs to monitor this fine line carefully and with legal guidance to ensure that all stakeholders' interests are correctly managed.

FUNDERS

Banks are the most common source of funds and normally have the important negotiating leverage of being secured funders. However, as capital structures become more complex so too does the communication and management of interests. In the simplest form a company will have one bank and refinancing discussions are relatively straightforward. Whatever the level of complexity the success or otherwise of discussions with funders will depend on the provision of regular, accurate and credible financial information.

In more complex cases there may be different layers of debt with senior and junior debt having different rankings and security. Debt may have been syndicated across a group of banks and while communication will normally be through an agent bank, standstill agreements and waivers may require majority agreement and restructuring may require unanimous consent. The lenders' interests are not always aligned and discussions can be time consuming. Minority hold outs to maximise leverage can endanger the turnaround process. It is essential that the process of discussion and the need for ever more financial information does not detract a CRO from the process of running the business and managing the operational turnaround. Demands on time need to be carefully managed and responsibilities delegated and monitored effectively.

The negotiation process of the financial restructuring, particularly leveraging off the threat of insolvency, is addressed in Negotiating the financial restructuring. These negotiations are fundamental in ensuring the company can emerge from its distressed position with a level of debt on its balance sheet that operational cash flows of the restructured operations can support. For this reason a turnaround is a combination of success in stabilising a business and charting a credible recovery, and negotiating a funding structure that does not impose excessive leverage on the emerging business. The more successful the operational turnaround process is then the easier it will be to negotiate an acceptable level of debt with

the funders. It is in their business interest to lend to profitable companies.

ESTABLISHING THE FORECASTS AND BUSINESS PLAN

THE SHORT-TERM SURVIVAL AND RECOVERY PLAN

At the outset the emphasis is on liquidity, avoiding insolvency triggers, communications to critical stakeholders and short-term cost control. The turnaround manager must act quickly and take the leadership role in establishing short-term actions and delegating responsibilities for action. There is normally not time for a formal planning process so a series of quick fixes should be documented and regularly reported against. This should be daily at first and moving to less frequent action and follow-up meetings as circumstances permit. All senior management should be involved and by conference call for remote executives if necessary. The short-term cash forecast will be the driver of the actions. The issues raised and the performance of management in resolving them will highlight key problem areas and problem people. The process itself will buy time for a more in-depth assessment of the business issues and serve as a basis upon which to formulate a longer-term business plan.

THE BUSINESS PLAN

Most companies have a budget and planning process and some have a strategic planning process. These processes should be used as a basis of reassessing the current strategies and operating plans and creating a revised financial plan which will serve as the primary document in negotiating financial restructuring with the stakeholders.

As existing plans have invariably been missed there will be doubt over the effectiveness of the planning process and its relevance to current circumstances. A common deficiency of plans is that they have been prepared at too remote a level from the operational management. They can be over optimistic and without buy-in from the operating personnel. Accordingly there can be a lack of ownership from the people responsible for achievement and a corresponding likelihood that targets will be missed.

The turnaround manager must avoid this pitfall and ensure that the new plan is constructed from the bottom up and not the top down; from operating departments' reasoned input and not from the finance department or managing director's wish list. It must be based on reliable external market data, achievable market shares and supportable gross margins. Operating costs should be zero-based and all unnecessary costs eliminated.

GUIDELINE

Restructuring costs for disposals and redundancy programmes should be built in. Cash flow forecasts should be on a receipts and payments basis and highlight major exceptional items. From this plan funding parameters can be established which will serve as the basis for negotiating refinancing alternatives. Plans should cover a five year time horizon with the first two years monthly and following years quarterly, particularly if the business has a seasonal nature.

VALUATIONS AND INDEPENDENT BUSINESS REVIEWS

It is probable that as part of the negotiating process existing or potential funders will require independent assessment of asset values and of the viability of the business plan from reputable business valuation companies and reporting accountants. Consideration should be given to the timing of such assessments as they add expense to the process at a time when costs are under scrutiny and cash availability tight.

Asset valuation may be required as part of the lenders' assessment of liquidation value described in the next section. They can be on a break-up basis and a going concern basis, the former being part of the liquidation value.

EXAMPLE 9

On an assignment of a golf club and chalet development a bank lender with £750,000 of secured loans and overdrafts called in the overdraft while the development was still in process. An independent valuation of £1.7m gave sufficient comfort for the bank to maintain the facility while alternative funding was sought. Administration was avoided.

Independent business reviews (IBRs) may be requested by senior lenders at a later stage in the turnaround process when the business plan has been completed and refinancing negotiations have started. These are normally carried out by firms of accountants or turnaround specialists.

EXAMPLE 10

On an assignment of a large international quoted company the syndicate members requested an IBR covering both the break-up value in administration and the business plan which had a proposed debt to equity swap and payment-in-kind (PIK) note component in the debt restructuring, the PIK note entitling the holders to receive deferred payment when certain future performance criteria were met. The company business plan forecast a full recovery for the syndicate over an eight-year period compared to a possible 30% recovery in administration. The IBR forecast a possible 35% recovery in administration and a 90% probability of full recovery over time. The conclusion in the IBR was critical to acceptance of the plan by the various syndicate members who required an independent appraisal for their respective credit committees.

TAXATION ISSUES

While taxation may not be uppermost in the minds when trying to turn around a business almost any group reorganisation will have a tax effect on the business and an evaluation of the impact of the tax affairs of the business may become important in deciding the best route to take. For example, if tax losses cannot be used by a restructured business this will have a material impact on its future cash flow. Tax losses may generally be preserved outside of insolvency but lost in an insolvency or change of business.

The turnaround manager should seek advice from tax specialists before embarking upon a financial restructuring. A restructuring involving forgiveness of debt, disposal of all or part of a business, or a debt to equity swap may have a tax impact and the turnaround manager should never be faced with a situation where he discovers late in the day that his proposed restructuring, that would otherwise have succeeded, has been undermined by lack of consideration of tax issues and their effect on cash balances early on in the process.

Taxation issues that may arise in a turnaround situation include:

- potential corporation tax charge on any buy back of debt at a discounted amount as the difference between the face value of the loan and amount paid may be treated as profit if there is no change of control of the company;
- potential tax on capital gains following the sale of assets or business segments;
- stamp duty that may be payable if the company's restructuring involves the converting of debt into some form of equity;
- loss of all or part of carry forward tax losses; and
- VAT on sale of assets including goodwill.

NEGOTIATING THE FINANCIAL RESTRUCTURING

LEVERAGING OFF ENTERPRISE VALUE PRESERVATION

In order to achieve any turnaround that requires the consent of creditors, the turnaround manager will need to convey the beneficial impact of the creditors' support. Central to this will be his demonstration that preserving the value of the business through supporting the turnaround will result in higher returns in the longer run than in the shorter term through the sale of individual assets.

MANAGING THE DIFFERENT LEVELS IN THE CAPITAL STRUCTURE

A financial restructuring with a company's debt being compromised will fundamentally change the net asset value of the business. The approach adopted should be fair and reflect the sacrifice that creditors have to make. Shareholders cannot expect to retain their existing economic interest and control intact when the holders of debts with greater security over the company and its assets are sacrificing that position in order to save the business. Ultimately any financial restructuring is likely to involve either a delay in or reduction to the amount returned to creditors and can also involve them taking that return perhaps in equity, PIK notes or convertible loans through their assumption of formal or partial control of the business. While shareholders may be unhappy at their dilution and disenfranchisement, it will more likely result in a better chance of recovery of their investment if it reflects the economic reality that the turnaround manager was initially faced with and his turnaround plan seeks to address.

ALTERNATIVES TO CONSENSUAL RESTRUCTURING

A consensual approach to restructuring of a company's business and assets, such as a debt for equity swap or a buy back debt by a company, is generally preferred as it is usually quicker, cheaper and avoids the perceived stigma of a formal insolvency process.

However, the turnaround manager may find that a consensual approach is not achievable due to continued creditor pressure and therefore in the UK a process under the Insolvency Act 1986 or the Companies Act 2006 will need to be considered. This may occur in situations where the company's cash flow is insufficient to service even restructured debt or where the company's creditor

population is large and complex and creditors are not minded to support a proposed consensual restructuring. In cross-border situations, the processes and issues will differ from those in the UK.

ADMINISTRATION

Administration, or the threat of it, is increasingly intertwined with turnaround where creditor pressure or onerous liabilities cannot be consensually resolved. In the event that a company is insolvent or is about to become insolvent, an Administrator can be appointed under the provisions of the Insolvency Act 1986 to manage its affairs. The company and its assets are placed under the control of an Administrator and the protection of the court with the rights of unsecured creditors frozen until the Administrator produces his recommendations on how to deal with the company's affairs and assets. The options are to continue trading the business while seeking a buyer, to close the business and seek a buyer or alternatively if no buyer emerges, to sell off the assets of the business for the benefit of the creditors.

Administrators can be appointed either out of court by the company, its directors or by the holder of a qualifying floating charge or by the court upon application of the company or its directors (or one or more of its creditors, the holder of a qualifying floating charge or an appointed liquidator).

The statutory purposes of an administration are:

- to attempt the rescue of the company as a going concern;
- in the event that the point above is not possible, to achieve a better result for the creditors as a whole than would otherwise be achievable in a liquidation; or
- when the above are not reasonably practicable, to realise the assets for the benefit of one or more of the secured or preferential creditors.

Where a rescue of the company itself cannot be achieved the Administrator's efforts would be directed towards maximising the return to creditors from a sale of the business and its assets as a going concern in whole or in part. This could take the form of a sale following a marketing campaign in which the business is offered for sale. During the marketing campaign the business may continue to trade if there are sufficient funds to cover operations or it may be closed.

CVAs, SCHEMES OF ARRANGEMENT AND PRE-PACKS

A CVA is a process under the Insolvency Act 1986 in which a company does not need to be insolvent to use these provisions. It is managed under the control of an insolvency practitioner, and creditors are treated in

GUIDELINE

accordance with the provisions of the Insolvency Act 1986. CVAs may only offer enhanced returns to one group of creditors in specific circumstances if 75% by value of debt of all voting creditors, excluding secured creditors unless they have valued their security, consent to the CVA proposal. CVAs are usually considered as a viable alternative in any restructuring situation, particularly as a means to cram down dissenting creditors due to the 75% voting requirement for approval of the CVA. There are no unsecured creditor or shareholder class issues involved in CVAs and they are usually quicker, simpler and cheaper to implement than a scheme of arrangement (a Scheme), and they do not involve the same degree of court involvement.

A Scheme is a court driven process pursuant to the Companies Act 2006 and is normally used only where the company's business and structure is large and complex. As noted above, creditor classes are determined by their economic stake in the business and a Scheme can treat different creditor classes differently. A Scheme can bind creditors and shareholders who have no economic interest in the company's assets and is typically used in financial services businesses such as insurers and lenders.

Pre-packs attempt to avoid the perceived negative stigma of a lengthy insolvency process and are considered to be potentially the best way to extract value from a business when the risk of damage to reputation and loss of customers and key staff through negative publicity is high. Pre-packs allow time for due diligence to be undertaken in advance while causing minimal disruption to the business.

Pre-packs can be seen as a controversial approach and great care must be taken to consider the transaction carefully to ensure that creditors' interests are not harmed by the sale. As the business and assets are not usually openly marketed, there is a risk that the best price has not been obtained. Administrators have a duty to maximise returns to creditors and need to be satisfied that any pre-pack represents the best, or indeed only, deal available to creditors in the circumstances. Accordingly care should be taken to justify valuations by independent means where possible.

PENSIONS AND LEASES

As part of his assessment of the company's liabilities, the turnaround manager will have identified whether the company has a defined benefit pension scheme and/or a large number of leases. In these situations, special consideration will need to be given to any proposed restructuring of the company and its business and the turnaround manager will need to communicate with these stakeholders from the outset.

Should the company's defined benefit pension scheme have a large deficit, it is common for this amount to

represent a considerable part of the total amount of unsecured creditors. The company has various obligations to the trustees of the pension scheme, including a requirement to keep the trustees informed of the company's situation. In the UK, the Pensions Regulator and the Pension Protection Fund have numerous legislative powers in this situation and will need to be consulted in relation to the company's proposed restructuring.

In the UK the *Nortel* ruling in the High Court in 2010 created uncertainty in relation to whether or not a pension scheme deficiency should be treated as an expense of an insolvency process, thereby ranking ahead even of the administration fees, or as an ordinary unsecured creditor. Accordingly, this will have an impact both on the willingness of an insolvency practitioner to accept an appointment if payment of fees is in doubt and on the return to unsecured creditors. Both the likely amount and its priority must be considered by the turnaround manager when formulating his restructuring plan.

Should the company have excessive and/or onerous leases, consideration needs to be given to how these will be dealt with as part of the overall restructuring. In certain situations, the formal restructuring processes available may assist with the disposal of surplus leases at terms acceptable to the affected landlords or may also allow the company to vary onerous rent level or payment terms under continuing leases. The CVAs of large retail groups during the 2008-2010 recession are examples of how CVAs can be used to deal with onerous leases. However, landlords can be reluctant to compromise their legal rights unless there are overwhelming commercial benefits to themselves.

MANAGING HOLD OUTS

A hold out is a situation where a minority group of creditors, normally of a specific type or class, have sufficient rights to block restructuring proposals that the company or an office-holder is attempting to put into effect through the restructuring method being adopted. The purpose of this approach is to extract concessions from the proposed settlement with creditors that are not reflective of their relative economic interests. A turnaround manager will be keen to avoid such collective obstruction to his turnaround plans. It will be important to obtain legal advice early on in the process where a complex restructuring is contemplated so that he can be aware of the relative positions that different creditor groups may take – or the potential grounds on which he can challenge such collective action, if necessary by resorting to the courts. Various options to cram down hold outs may be considered and resorting to CVAs, pre-packs or schemes of arrangement can be required to achieve a settlement. Sometimes merely the threat of such action can be sufficient to secure agreement.

EXITING THE LEADERSHIP ROLE

A CRO'S ROLE SHOULD EVAPORATE WITH TIME

It is not possible to forecast exactly when a CRO should leave an assignment. In practice it will become self-evident as the new management structure demonstrates its ability to perform and hit plan targets. In the event that the company is disposed of as part of the turnaround, it will be probably when the disposal is complete and the buyer takes control. It is normal that the need for supervision will also reduce from full time to part time as the business recovers.

CHOOSING THE EXIT DATE

Company internal management may wish to expedite the exit date for both cost and independence reasons. However, the concerns of other stakeholders should be taken into consideration. Customer confidence may be eroded by too early an exit. Management credibility may not have been sufficiently restored for suppliers to maintain credit lines. Above all the confidence of funders needs to be maintained. Not all turnaround recoveries go exactly to plan. Significant deviations may need renegotiations of finance terms.

EXAMPLE 11

At a subsidiary of a US auto supplier the US parent terminated the CRO against advice once an upturn in performance had started and a new managing director installed. The new management team could not maintain hard won customer confidence and key contracts were lost. The CRO returned within a year but only to put the company into liquidation.

MAINTAINING A MENTORING AND MONITORING ROLE

Having built up knowledge of the business and gained the confidence of internal and external stakeholders, shareholders or boards may request that the turnaround manager maintains contact either in a non-executive director role or as an external adviser. This may also be a requirement of the financial restructuring terms.

MANAGING INTERNATIONAL AND CROSS-BORDER ISSUES

Business is global and so too is business distress. Many large businesses and SMEs in the UK have overseas subsidiaries which can be dependent on intercompany trading. Turnaround managers can be faced with immediate insolvency issues in other jurisdictions where insolvency laws and directors' liabilities are different from the UK. Knowledge of distress moves quickly and a turnaround manager could be faced with a potential insolvency filing of a subsidiary which could have significant knock-on effects throughout the group. Recognising the dangers and acting quickly to seek competent local advice is necessary.

INSOLVENCY TRIGGERS AND DIRECTORS' LIABILITIES IN KEY JURISDICTIONS

In most jurisdictions the most pressing insolvency trigger is a lack of liquidity. In some it may be a balance sheet test of insolvency in which asset and liability valuations may be unclear and subjective. And because directors' liabilities can be perceived as more onerous than in the UK, local directors may dash to the courts to file for insolvency when alternative actions could prevent this.

EXAMPLE 12

In an assignment of a distressed international group with its continental European subsidiaries managed from Brussels, the local managing director made a decision to file for Belgian insolvency because of personal liability concerns raised by his own legal adviser. The UK-based CRO paid an immediate visit to Brussels and, acting under the corporate legal counsel's advice, relieved the managing director of his position. The filing was averted and in due course the European subsidiaries disposed of to an Italian buyer.

When taking an appointment in an international group a CRO should make an immediate assessment of subsidiary insolvency risk and put into place measures to control and monitor the situation.

GUIDELINE

MANAGING CASH IN A CROSS-BORDER TURNAROUND

Critical to the management of overseas subsidiaries is the management of cash in each subsidiary. Although larger companies with centralised treasury functions may have daily cash sweeps channelling cash balances into a centrally controlled account it is more normal for most subsidiaries to have their own banking facilities and control of cash. At an early date these subsidiaries should be incorporated into the 13 week cash flow reporting regime. It is human nature for local finance managers to protect the local company position. Reports may understate cash availability or headroom. Third-party payments may be made from available funds ahead of intercompany payments denying a fellow subsidiary with a more pressing cash need. Monitoring the use of intercompany funds for the optimum group need requires regular reporting and regular checking, if possible by having internet access to subsidiary bank accounts.

EXAMPLE 13

On an assignment involving 15 subsidiaries in nine European companies the UK-based treasurer and CRO chaired daily cash conference calls monitoring cash usage and sanctioning payments above a pre-determined minimum threshold. By husbanding scarce cash resources the group avoided an unintended insolvency trigger in any of the subsidiaries while a longer-term strategy and plan was determined.

RISKS AND REWARDS

FEE STRUCTURE AND BILLING ARRANGEMENTS FOR NEAR INSOLVENT CLIENTS

Getting assignments is one challenge. Getting paid is another. By definition a distressed company has many conflicting and pressing cash needs. A method of assuring payment is fundamental because without it a professional becomes a financial stakeholder and objectivity will be eroded. Most CROs and restructuring firms require a deposit equating to two or three weeks' estimated fees to be paid in advance of starting work with weekly billings for immediate payment so that the deposit covers any outstanding fees. To ensure transparency the fees should be built into the 13 week cash forecast. Stakeholders usually recognise the benefit of professional advice to their position and willingly accept the arrangements as if they were payroll obligations in their own organisations.

SUCCESS FEES

Company owners and directors often promote the concept of success fees as it clearly aligns the turnaround manager's interests with their own. How much and when they are activated will depend on the nature of the assignment. It is preferable that they do not constitute the major percentage of total fees. They should be capable of clear definition and measurement, and where possible easily recognisable milestones in the turnaround process. Once a turnaround is achieved a CRO has little negotiating leverage in claiming disputed amounts. Possible milestones are: return to cash positive operations, return to profitability over a three-month aggregate period, disposal of a subsidiary, securing a refinancing agreement, and exit from a bank work-out.

EQUITY STAKES

In larger companies this may be considered where the amount is insignificant to the total equity and stakeholder interests are not compromised by a lack of objectivity. In some smaller assignments, where the business would not ordinarily be able to afford the reasonable fee level of a turnaround manager, giving an equity stake may be the only way a company can engage a turnaround professional and save the company from bankruptcy. This is especially relevant to private companies where the interests of both the shareholders and the turnaround manager can be aligned to saving the business. Such arrangements should be transparent to other significant stakeholders to ensure the integrity of the process is not undermined when it inevitably becomes known.

SUMMARY AND CONCLUSIONS

Effective turnaround management involves a combination of operational and financial skills and an appreciation of the legal issues affecting directors' liability and the insolvency process. It requires the experience to inspire confidence in management, the integrity to command trust and respect among all stakeholders and the tenacity to persevere to reconcile often conflicting objectives. It is a team effort involving internal management and external advisers focused on the objective of enterprise value preservation.

The start is controlling liquidity to achieve a stable base to allow time to determine the viable core business and develop a credible business plan. Implementation of the plan and negotiation with the stakeholders using whatever leverage exists follows, during which time an appropriate management team can be established to take the business

forward, and a funding structure can be negotiated which the new business model can support from operational cash flows.

Turnaround and restructuring is evolving towards consensual restructuring as a preference over formal insolvency where value can be preserved, while leveraging negotiated concessions off the threat of insolvency or by using available processes to avoid onerous legacy costs. It can often be a fine judgement line between filing for insolvency to seek protection from pressing creditors, or attempting a turnaround and financial restructuring in an environment of creditor pressure and legal threats and counter threats.

Legislation and process are evolving too, attempting to effect an optimum balance between creditor and debtor interests. The legislation provides the framework in which the turnaround is effected. It is the professional team's management of the stakeholders' often conflicting objectives that determines the optimum process and the optimum result.

While customers and key employees are liable to leave after a filing taking goodwill with them, rescue outside of formal process driven by competent turnaround professionals will, where a viable core business exists, afford the better solution to the benefit of all stakeholders. It is also a more efficient process of value preservation and use of capital for society in general.

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Alan Tilley is a founding principal of Bryan, Mansell and Tilley LLP. He has significant expertise in turnaround and restructuring, managing the complex issues in preserving enterprise value while operating in the zone of insolvency. He is a frequent speaker on cross-border European restructuring and has written several articles on the subject. He is the 2008 recipient of the TMA International Chairman's award for outstanding service to the international turnaround and restructuring profession and won the Turnaround Practitioner of the Year award at the 2010 insolvency and restructuring awards for BM&T's work on La Seda de Barcelona. Alan is VP of International Relations for TMA worldwide.



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David Bryan is a founding principal of Bryan, Mansell and Tilley LLP and an experienced hands-on senior financial manager with extensive experience working with international and UK companies in restructuring and improvement. He has operated at CFO level in large and SME companies in the UK, US and Continental Europe and has many years experience with public and private equity owned businesses. Industry experience includes automotive supply and commercial vehicle manufacture, industrial systems and services. David is on the board of TMA UK and TMA Europe.



**Bryan, Mansell
& Tilley LLP**

BM&T is an organisation of senior turnaround management professionals headed by David Bryan, John Mansell and Alan Tilley. With a combined 30 years of experience in turnaround and restructuring of underperforming businesses the three principals were previously senior professionals in Glass Europe, a division of US based Glass & Associates, a pioneer in the field of turnaround management.

In Europe the principals of BM&T and our German and other European associates have successfully completed more than 50 engagements with companies ranging from €10m to €1.5bn, in all major industry sectors. BM&T is affiliated with Conway MacKenzie in the US and Gila & Co in Spain.

BM&T provides a range of turnaround management and performance improvement services to clients in a variety of industry sectors. These include financial restructuring, operations improvement, interim crisis management, operational due diligence, viability assessment, working capital improvement and business plan preparation.

BM&T has the cultural sensitivities, linguistic capabilities and understanding of local, national and international issues to operate effectively in local and cross-border crisis situations. The value we add is experience.

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Stephen qualified in 1993 and became a partner in a top 10 accountancy practice the following year. In 2000, he joined a professional and financial services group and became head of restructuring and recovery. He became a board director of this group in 2005.

Stephen left to lead Cork Gully LLP as Managing Partner. He has advised companies ranging from owner-managed businesses, main listed publicly quoted companies on the recovery strategies available, both at a board level as well as to their financiers.

**Katie Moffitt****Director****Cork Gully LLP****T** +44 (0)20 7268 2150**E** KatieMoffitt@corkgully.com

Katie has over 13 years restructuring experience, beginning her insolvency career in 1998 in Australia and continuing in the industry since moving to the UK in 2003. She is a qualified Insolvency Practitioner, Chartered Accountant and a member of the Institute of Chartered Accountants of England and Wales. She joined the restructuring team at Cork Gully LLP in 2010 and has continued to work on a wide range of pre insolvency advisory engagements and formal insolvency appointments.

CORK GULLY

Built on a solid heritage, we are a specialist advisory firm bringing clarity to complex restructuring, recovery and insolvency issues.

We demonstrate our commitment to our clients through the delivery of innovative solutions to achieve the best possible outcome in often challenging circumstances.

As trusted advisers, we strive for the highest standards in every aspect of our work, continually revising and improving our offer while adopting best working practices. We have built on the core values of the firm established over a century ago and which remain relevant today.

As an independent firm we are responsive, agile and rarely affected by conflicts of interest. Our clients have complete confidence in our ability to engage and act on their behalf promptly on an extensive range of issues.

ICAEW CORPORATE FINANCE FACULTY

The Corporate Finance Faculty is the largest network of professionals involved in corporate finance. It includes more than 5,000 members and more than 70 member organisations. They are drawn from major professional services groups, specialist advisory firms, companies, banks, private equity houses, law firms, brokers and consultants.

The faculty was established by ICAEW in 1997. It is a centre of professional excellence in corporate finance, contributing to consultations by international organisations, governments, regulators and other professional bodies.

The faculty supports continuing professional development (CPD) by providing a wide range of services, events and publications to its members, including its award-winning magazine *Corporate Financier*. The faculty initiated the development of the first international Corporate Finance qualification (including the 'CF' designation) for practitioners, which was launched in April 2005.

ICAEW is a professional membership organisation, supporting over 136,000 chartered accountants around the world. Through our technical knowledge, skills and expertise, we provide insight and leadership to the global accountancy and finance profession.

Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value.

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